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**In the United States Court of Appeals
for the Ninth Circuit**

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BELRIDGE OIL COMPANY, RESPONDENT

**On Petition For Review Of the Decision Of the
Tax Court Of the United States**

BRIEF FOR THE PETITIONER

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v.

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On Petition For Review Of the Decision Of the
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BRIEF FOR THE PETITIONER

OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 79-104) are reported at 27 T. C. 1044.

JURISDICTION

This petition for review (R. 113-117) involves federal income and excess profits taxes for the taxable year 1950. On May 28, 1954, the Commissioner of Internal Revenue mailed to taxpayer a notice of a deficiency in the total amount of \$43,746.32 (R. 21-26.) Within 90 days thereafter and on August 18, 1954, the taxpayer filed a petition for a redetermination of that deficiency under the provisions of

Section 272 of the Internal Revenue Code of 1939. (R. 3, 5-34.) The decision of the Tax Court was entered on July 26, 1957. (R. 112.) The case is brought to this Court by a petition for review filed October 18, 1957. (R. 113-117.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

The taxpayer was the owner of fee interests in two separate depletable parcels of land from which oil and gas were being produced from two or more depths or zones, including one, called the 64 Zone, which also underlay properties belonging to other oil companies. Effective as of February 1, 1950, the taxpayer and five other oil companies entered into an agreement for the unitized production of oil and gas from 64 Zone on a cooperative basis, under which the taxpayer's participating share was 71.87 percent of the production from the entire zone.

The question presented is whether in entering into this unitization project the taxpayer created a new interest on which it must compute its depletion allowance as to 64 Zone, under Sections 23(m) and 114(b) (3) of the Internal Revenue Code of 1939, as the Commissioner contends, or whether, as the Tax Court held, the taxpayer continued to have only two separate interests for depletion purposes.

STATUTES AND REGULATIONS INVOLVED

The relevant portions of the statutes and Regulations involved are set forth in Appendix A, *infra*.

STATEMENT

The stipulated facts (R. 38-51) and the findings of fact made by the Tax Court (R. 82-96) may be summarized as follows:

The taxpayer is a California corporation which has been engaged for many years in the business of producing oil and gas. In 1911 it acquired fee simple ownership of 30,845.96 acres of land, known as the "Main Property," on which two separate oil and gas production fields, known as the North and South Belridge fields were developed. On September 1, 1944, the taxpayer purchased the working interest and the landowners' and royalty owners' rights in a producing property known as the Result Property, consisting of 80 acres adjacent to the North Belridge field. (R. 82.)

Prior to 1950, the taxpayer had completely recovered its tax basis for its Main Property through cost depletion allowances and therefore computed its allowable depletion deduction by the percentage depletion method. On the Result Property the depletion allowance based upon adjusted cost has been consistently greater than the percentage depletion allowance. On its tax return for 1950, therefore, the taxpayer claimed cost depletion on its Result Property and percentage depletion on its Main Property, as it had done in previous years. (R. 93-94.)

There are five different depths or zones from which oil and gas are produced from the North Belridge field: the Shallow Zone (which produces from relatively shallow depths), the Temblor Zone (approx-

mate depth—6,000 feet), the R. Zone (approximate depth—7,000 feet), the 64 Zone (approximate depth—8,000 feet) and the Y. Zone (approximate depth—9,000 feet). The 64 Zone and the Temblor Zone also underlie portions of the taxpayer's Result Property. (R. 82-83.)

The 64 Zone is the largest developed oil and gas reservoir underlying taxpayer's Main and Result Properties. This zone also underlies portions of adjacent and nearby land owned or operated by five other oil companies. The gas cap of the 64 Zone is located principally under the taxpayer's land and, by lessening or increasing gas cap pressure, oil can be moved up or down structure from the taxpayer's land. Prior to October, 1941, production by all companies operating in the 64 Zone was entirely on a competitive basis. Oil production from the 64 Zone reached approximately 12,000 barrels a day by 1938, but after 1938 the reservoir pressure and oil production from the zone steadily declined. From October, 1941, to April 1, 1947, a voluntary gas pressure maintenance program, whereunder a portion of the gas produced from the zone was returned to the reservoir, was put into effect by the companies producing from the zone. During the period from April 1, 1947, until February 1, 1950, the six companies producing from the 64 Zone abandoned this program and resumed unrestricted competitive production. (R. 83.)

On July 1, 1949, the taxpayer and the five other companies producing from the 64 Zone entered into a unitization agreement providing for production of oil

and gas from the zone on a cooperative basis. Generally speaking, the agreement, which became effective on February 1, 1950, provided that, as to 64 Zone oil, development and operation of the properties of the six participants was to be conducted on a cooperative basis by a designated operator and that each participant was to receive a specified percentage of all the oil, gas and associated hydrocarbons produced. (R. 84.) The major portion of the agreement (Stip. Ex. 3-C, R. 39) is printed in Appendix B. *infra*.¹

Each of the participants in the unitization agreement had "Participating Equities" as follows (R. 91):

Participant	Participating Equity and Tract Value Assigned
Belridge Oil Company	71.87%
Tide Water Associated Oil Company	16.58%
Richfield Oil Corporation	4.44%
The Texas Company	4.44%
Standard Oil Company of California	1.48%
Union Oil Company of California	1.19%

The taxpayer, Tide Water, Richfield and Standard had fee simple ownership of the tracts contributed by them to the unitization project. Union Oil Company also owned one of the three tracts which it contributed to the project in fee. The other two tracts

¹ Copies of Exhibit 3-C, the unitization agreement, and of Exhibit 4-D, a supplemental agreement relating to accounting procedure, have also been furnished the Court by taxpayer.

held by Union were held under leases as were the tracts of the Texas Company. (R. 91.) The participating equities allotted to each of the companies approximated the percentages of the total production from the 64 Zone which each had obtained during the period of unrestricted competitive production which immediately preceded the effective date of the agreement. (R. 91-92.)

Consents to the agreement were exercised by a number of the lessors and royalty owners who had interests in the 64 Zone covered by leases held by the Texas Company and Union Oil. The other participating companies (the taxpayer, Tide Water, Richfield and Standard), who together owned in fee 92 percent of the land covered by the agreement, did not execute lessors' and royalty owners' consents. (R. 92-93.)

The portions of taxpayers' two properties which were affected by the unitization agreement were the 64 Zone underlying its Result Property and the 64 Zone underlying some, but not all, of its Main Property. The agreement did not affect any of the other zones underlying the taxpayer's land; taxpayer and the other five participating companies continued to operate and produce from one or more of the other zones underlying the surface area of their respective properties covered by the agreement. The taxpayer took no production from the Temblor Zone of its Result Property during the years 1949 to 1953, inclusive, but in 1954 it resumed production from that zone. (R. 92-93.)

Under the unitized operation in 1950 (February 1 through December 31) a total of 428,139 barrels of oil were produced from the 64 Zone. Of this amount, 21,672 barrels were produced from wells located on taxpayer's Result Property, 215,390 barrels were produced from wells located on its Main Property and 191,077 barrels were produced from wells located on the property of other participants. The taxpayer's 71.87 percent share of production under the unitization agreement was 307,704 barrels, or 70,642 barrels more than that produced from wells located on its property. (R. 93.)

The taxpayer, on its tax return for 1950, claimed cost depletion on its Result Property and percentage depletion on its Main Property, as it had done in previous years, and allocated its unitized share of 64 Zone oil to the two properties. (R. 94.) The Commissioner determined that by virtue of the unitization agreement the taxpayer had a single depletable interest in the unitized 64 Zone and that the statutory percentage depletion allowance computed thereon would give taxpayer the maximum allowable deduction for depletion. (R. 95-96.) The Tax Court held that taxpayer retained its original separate depletable interests in 64 Zone oil. (R. 96-104.)

STATEMENT OF POINTS TO BE URGED

The points urged by the Commissioner are detailed in our Statement of Points (R. 117-120.) Briefly, it is the Commissioner's position that the Tax Court erred in holding that the unitization agreement did

not create a new, separate and single depletable interest in respect of taxpayer's share of unitized 64 Zone oil.

SUMMARY OF ARGUMENT

For depletion purposes under Sections 23(m) and 114 (b) (3) of the Internal Revenue Code of 1939, the taxpayer's contribution of its interest in the 64 Zone of oil and gas, underlying its Main and Result Properties, into a unitization project entered into with the five other companies which had working interests in the 64 Zone, in return for a 71.87 percent share of production from the entire unitized zone, resulted in the creation of a new, separate and single interest in respect of 64 Zone oil. Under the Code and Regulations the depletion allowance is made with respect to each separate "property", defined in the Regulations as the interest owned by the taxpayer in each separate "mineral property", which in turn is defined in such a way as to mean an operating or production unit. Thus "property" for depletion purposes means any depletable interest in a production unit. An interest in a unitization project is a substantially different interest from other types of oil interests and is therefore a separate "property" for depletion purposes.

The unitization agreement involved here clearly created a separate operating unit and separate interests therein as to 64 Zone oil. The oil from the zone was produced, and treated for accounting purposes, on a unit basis. All of the expenses of production of oil from the zone were shared by the partici-

pants in proportion to their shares of production and the participants owned the equipment and facilities of the unit project as tenants in common. Each participant was entitled to receive a percentage share of the total oil produced by the unit. Although each participant was free to develop and produce oil from other zones or strata on its own land, the unitized interest in the 64 Zone was carved out and treated as a separate transferable interest. The taxpayer, after entering into the unitization agreement, could no longer produce separately from the 64 Zone underlying its land. Its only interest in 64 Zone was a unitized percentage interest—in all of the 64 Zone oil and in its production on a unitized basis—and it was only that interest which taxpayer could transfer to others. That interest, moreover, was created to endure so long as oil and gas could be economically produced from the zone, or until all parties, by unanimous agreement, chose to abandon the project.

In view of all this, the Tax Court's holding that the unitization agreement did not create a new, separate and single depletable interest, and that taxpayer may allocate its unitized share of 64 Zone oil to its Main and Result Properties, is both unrealistic and formalistic. Indeed, after the instant case, the Tax Court itself recognized that unitization can result in the creation of a new and different economic or depletable interest. In failing to hold that a new and separate depletable interest was created by the instant unitization agreement, the Tax Court erred and should be reversed.

ARGUMENT

For Depletion Purposes Under Sections 23(m) and 114(b)(3) Of the Internal Revenue Code of 1939, the Unitization Agreement Created a New, Separate and Single Interest In Respect of Taxpayer's Share Of 64 Zone Oil.

No question is here presented as to the taxpayer's right to a depletion deduction on 64 Zone oil; the inquiry is merely as to the amount of that deduction and, more specifically, as to the unit basis for its computation. The taxpayer was the fee owner of two tracts of land, one called the "Main Property" and the other the "Result Property." Prior to 1950, the taxable year, the taxpayer produced oil and gas from the various zones (including 64 Zone) underlying the Main and Result Properties, which were concededly separate properties for depletion purposes. In 1950, however, the taxpayer contributed its interest in one of the zones underlying both properties, 64 Zone, to a unitization project entered into with the five other oil companies who had working interests in adjoining land from which they too produced from 64 Zone. In return, taxpayer received a 71.87 percent share of the production from the entire unitized zone. Despite the unitization of the 64 Zone oil, the Tax Court held that taxpayer is entitled to allocate part of its unitized oil to its Main Property, on which it took *percentage* depletion, and the other part to the Result Property, on which it took *cost* depletion.² It is

² Taxpayer is claiming cost depletion on a part of the unitized oil because, as the Tax Court stated (R. 98), the result is a higher depletion deduction than if percentage depletion is taken on all of the unitized oil.

our contention that, as to the 64 Zone oil, the unitization agreement created an additional, new, separate and single depletable interest, so that taxpayer must compute its depletion on its 71.87 percent share of production from the unitized 64 Zone as one depletable interest.³

In Section 23(m) of the Internal Revenue Code of 1939 (Appendix A, *infra*), Congress has authorized the deduction, in the case of mines, oil and gas wells, and other natural deposits, of—

a reasonable allowance for depletion * * * according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

Section 114(b)(1) of the Code entitled "General rule" and having reference to *cost* depletion, provides for depletion on the adjusted basis in respect of any "property". Section 114(b)(3) (Appendix A, *infra*) authorizes *percentage* depletion, in the case of oil and gas wells, of 27½ percent of the gross income from the "property" (not to exceed 50 percent of net income). Each separate "property" is a separate depletable unit (Treasury Regulations, Section 29.23(m)-1(i) (Appendix A, *infra*); Breeding and Burton, *Taxation of Oil and Gas Income* (1954), p. 117) but the word "property" is not here used in the ordinary sense. For tax purposes, the

³ We, of course, concede that the Main and Result Properties are separate depletable properties as to the oil produced therefrom other than 64 Zone oil.

fee ownership of land (as related to oil production) and each of the various kinds of oil interests (e.g., leasehold and royalty interests) have significance only as property constituting as "economic interest" in the oil in place, a term which is synonymous with a depletable interest and means an interest from which the receipt of profit depends solely upon the production of oil in which the owner of the interest is deemed to have his capital investment. See, e.g., *Kirby Petroleum Co. v. Commissioner*, 326 U. S. 599; *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25. Thus, for the purposes of the depletion deduction the word "property" is defined in Treasury Regulations 111, Sections 29.23(m)-1(b), (c) and (i), as meaning "the *interest* owned by the taxpayer * * * in each separate mineral property" (italics supplied) and "mineral property" is defined as "the mineral deposit [meaning "minerals in place"], the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction." Accordingly, "each separate interest owned by the taxpayer in each separate tract or parcel of land" is a separate depletable unit.⁴ G.C.M. 24094, 1944 Cum. Bull. 250, 252.

It is apparent, therefore, that for depletion purposes as related to oil and gas production, "property" means any depletable "interest" in oil production. There are many established types of depletable oil

⁴ This definition has been adopted by Congress in Section 614(a) of the Internal Revenue Code of 1954.

interests, such as a fee, leasehold, royalty, and net profits interest and an oil payment right. See, e.g., *Palmer v. Bender*, 287 U. S. 551; *Kirby Petroleum Co. v. Commissioner*, 326 U. S. 599; *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25; *Thomas v. Perkins*, 301 U. S. 655. As to the very same operation, usually by fee or leasehold owners, the owners of any one of these various interests have a separate depletable interest or "property". *Id.*; *Helvering v. Jewel Mining Co.*, 126 F. 2d 1011 (C. A. 8th). While some of the recognized depletable interests are quite similar, such as a royalty interest and an oil payment right (see *Anderson v. Helvering*, 310 U. S. 404, 409-410), the similarity of the interests does not make them any the less separate and distinct "property" for depletion purposes. A unitized interest differs from all other types of oil interests and is therefore also separate "property" for depletion purposes.

It should particularly be noted that each interest in a *separate operating unit* is a separate "property." As already shown, it is each interest in a "mineral property" which is a separate interest or "property", and "mineral property" is defined as meaning the minerals in place, the development and plant necessary for its extraction and so much of the surface of the land as is necessary for mineral extraction. This definition plainly contains the essentials to an operating unit of production. Thus, it is the operating unit which furnishes the basis for separation of the various types of depletable interests or "property." For example, tracts of land which are not contiguous geographically are treated as separate properties for de-

pletion purposes. See *Vinton Petroleum Co. v. Commissioner*, 71 F. 2d 420 (C. A. 5th), certiorari denied, 293 U. S. 601, rehearing denied, 293 U. S. 633. Similarly, each leasehold operation is a separate operating unit, to which other depletable interests may attach. For instance, although a single individual has several interests of the very same type, for example royalty interests, which attach to separate leasehold operating units, each interest is a separate depletable interest or "property."

In the present case we are concerned with a relatively new type of oil interest, a unitized interest. It is beyond dispute that the unitization agreement (Ex. 3-C, Appendix B, *infra*) created a *separate operating unit* as to the 64 Zone oil. Indeed, that is the very purpose of unitization, as even the Tax Court seems to have recognized. (R. 100). As the Fifth Circuit stated in *Campbell v. Fields*, 229 F. 2d 197, 199:

Unitization * * * represents development and operation of an oil pool as a unit. It involves the consolidation and merger of all of the interests in the pool and designation of one or more of the parties as operator. * * *

In the instant case taxpayer and five other oil companies joined together in a unitization agreement with respect to the production of 64 Zone oil underlying the properties of all participants. Under the agreement the 64 Zone oil was produced, and treated for accounting purposes, on a unit basis. (Ex. 3-C, Arts. II and III.) Separate equipment and facilities were used for the unit project and each participant not only paid its proportionate share of the expenses of

production but owned the equipment and facilities as a tenant in common with the others. (Ex. 3-C, Arts. V and VII.) Each participant was free to separately develop and produce oil from other formations or zones on its own land (Ex. 3-C, Art. IX), but the unitized interest of each was treated as a separate, transferable interest (Ex. 3-C, Art. XI).

Although the Tax Court did not think so, it is also clear that taxpayer's *interest* in the 64 Zone oil was different after unitization. Before unitization taxpayer's interest was in all the 64 Zone oil in place underlying, or which could be produced from operations on, its Main and Result Properties. After unitization taxpayer had a 71.87 percent interest in all of the 64 Zone oil in place which underlay or could be produced from the unitized operations on not only its own property but that of the other five oil companies. The difference, merely from the standpoint of quantum, is vividly portrayed by the fact that, although only 237,062 barrels of oil were produced from wells located on taxpayer's land under unitized operations in 1950, taxpayer's share of the unitized oil was 307,704 barrels. (R. 93.) No longer could taxpayer produce oil from 64 Zone on its own and with its own equipment. Instead, with benefits to itself obviously in mind, it became the owner, as a tenant in common, of the equipment used in the unitized operation and gave up its rights of production from its own land for a unitized interest in production from the lands of all participants. No longer could taxpayer transfer any interest with respect to 64 Zone other than its unitized interest, which, as

already stated, was a separate, transferable interest. That interest was also an ~~und~~^anduring one, for the unitization agreement was to remain in full force and effect as long as oil and gas could be produced from 64 Zone in sufficient quantities to pay the costs of production, unless the agreement was previously terminated by the *unanimous* consent of all participants. (Ex. 3-C, Art. XII, Sec. 2.) Each participant could sell, assign, transfer or otherwise dispose of its interest in the *land* involved but only subject to the unitization agreement (Ex. 3-C, Art. XI, Sec. 2), just as leasehold owners may transfer their interests subject to outstanding royalty and other interests. Clearly, the unitization agreement created a new, separate and single depletable unit consisting of a unitized interest in 64 Zone oil.

The Tax Court's holding to the contrary seems to have been based on two premises which are irrelevant. First, the Tax Court specifically rejected the Commissioner's argument that the unitization agreement resulted in an "exchange" by taxpayer of property of like kind within the meaning of Section 112(b)(1) (26 U. S. C. 1952 ed., Sec. 112). (R. 98-100.) But the Tax Court's rejection of that argument was on the technical ground that the unitization agreement "discloses no words of conveyance". (R. 99.) Actually, it is immaterial whether the unitization agreement resulted in a technical "exchange" of property by this taxpayer, and the Commissioner did not so limit his argument in the Tax Court.⁵ Precise char-

⁵ It was our position in the Tax Court, as here, that as to the 64 Zone oil the unitization agreement created a new,

acterization of the nature of the unitization transaction as to this taxpayer is unnecessary so long as the transaction resulted in the creation of a new, separate and single depletable interest. As the Supreme Court stated in *Palmer v. Bender*, 287 U. S. 551, 557, the depletion statutes apply to—

every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, *by any form of legal relationship*, income derived from the extraction of the oil, to which he must look for a return of his capital. * * * (*Italics supplied*)

For example, the execution of an oil and gas lease by a landowner for a lump sum consideration and future payments from production amounting to a royalty interest, as in *Burnet v. Harmel*, 287 U. S. 103, creates a new depletable interest (the royalty interest) even though, as the Supreme Court expressly held in the *Harmel* case, the transaction is not a sale or exchange of property. The tax statutes

separate and single depletable interest, so that taxpayer must compute its depletion on its 71.87 percent share of production from the unitized 64 Zone as one depletable interest (See e.g., R. 57, 58, 59, 64), and that position included a contention that there was a “merger” of interests as to 64 Zone oil. (R. 58, 64.) Lest taxpayer conceive our abandonment of the “exchange” theory and our present argument as a new argument, we call the Court’s attention to the fact that the main argument in our Tax Court brief (pp. 23-30) was under the following heading (p. 23): “Under the unitization agreement, petitioner’s separate operating interests in the 64 Zone were, in substance and effect, merged, consolidated, or exchanged for a single depletable property interest.”

covering sales and exchanges of property have reference to property constituting a capital asset and the retention of an economic interest in the oil and gas in place precludes a sale or exchange of such property, as in *Harmel*. But that does not preclude recognition of the effect of the transaction as creating a new interest, here, any more than in *Harmel* and other decisions of the Supreme Court involving the execution or so-called sales of oil and gas leases.

The Tax Court also stated (R. 100-101) that the "net effect" of the unitization agreement was a "joint effort" by the participants to "conserve" their respective "individual interests" by joining in a plan which left each with "exactly the same interests and rights in its respective properties after unitization as before" except that by mutual consent they had agreed to limit their production and operate their wells in the most economically feasible way. Since, as we have already shown, the unitization agreement clearly changed the participants' interests in and with respect to 64 Zone oil—even to the extent of giving them a new, separate, single, transferable and enduring property right—the Tax Court must have been thinking in some such terms as that the unitization did not effect a conversion of taxpayer's capital investment in 64 Zone oil.

While a capital investment in the oil in place is one of the two essentials to an "economic" (or depletable) interest (*Commissioner v. Southwest Expl. Co.*, 350 U. S. 308), a conversion of the capital investment is not necessary to create a new and different depletable interest. Indeed, it is precisely be-

cause of a taxpayer's *original* investment that he is deemed to have a *depletable* interest when by some transaction, such as the execution or transfer of a lease, he *creates and retains* a new type of interest, such as a royalty interest. See *Commissioner v. Southwest Expl. Co.*, *supra*, pp. 314-315; *Palmer v. Bender*, 287 U. S. 551, 558; *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25, 33-35. The original capital investment supports, rather than refutes, the conclusion that the new interest is a separate depletable interest.

The only important fact here, under the pertinent statutes and Regulations, is that unitization created a new and different type of interest in 64 Zone oil and in a new and different operating or production unit. Once different types of interests are created, they remain separate depletable interests so long as all of those interests are not merged to become identical to some larger interest. *Badger Oil Co. v. Commissioner*, 118 F. 2d 791 (C.A. 5th).

The Tax Court's decision in this case is unrealistic, not only as to the effect of the unitization agreement in respect of taxpayer's interest in 64 Zone oil but as related to the mechanics of computing taxpayer's depletion deduction on 64 Zone oil. The Tax Court would permit taxpayer to compute depletion on its unitized share of 64 Zone oil as if that oil were produced from taxpayer's own two properties, its Main and Result Properties, on one of which taxpayer takes percentage depletion and on the other of which it takes cost depletion. Actually, from February 1 to December 31, 1950, the unitized operations resulted

in the production of some 21,672 barrels of oil from wells located on taxpayer's Result Property (R. 93) but of course taxpayer's interest was not in that particular oil; it was in a stated percentage of the 64 Zone oil produced from all of the participants' properties. Thus, the Tax Court would permit taxpayer to allocate a lesser portion of its unitized oil (11,859 barrels) to the Result Property than the actual amount produced from that property. (R. 101-104.) This means, among other things, that taxpayer may be able to continue taking cost depletion on the Result Property long after the estimated reserves of 64 Zone oil on that property are exhausted. It also means that the Tax Court has not only permitted resort to an allocation of oil but has allowed the oil from one separate operating unit to be allocated to other operating units, whereas the very nature and separateness of taxpayer's unitized interest affords a simple and much more realistic basis for computing taxpayer's depletion deduction with respect to 64 Zone oil.

There is nothing new or novel in our position that, as to the 64 Zone oil, the unitization agreement resulted in the creation of a new, separate and single depletable interest. Although unitization is relatively new, some writers have already recognized that mineral interests may be classified as separate on the basis of unitization. See, e.g., P-H Oil and Gas, Taxes, p. 4019; Arthur Anderson & Co. Oil and Gas, Federal Income Tax Manual, p. 85. As a matter of fact, the Tax Court itself recognized, subsequent to its decision in the present case, that a new depletable interest can be created by virtue of a unitization

agreement. See *Whitwell v. Commissioner*, 28 T. C. 372, now pending on appeal to the Fifth Circuit.

Campbell v. Fields, supra, on which taxpayer relied in the Tax Court, is not in point. While it is the only tax case decided by a Court of Appeals involving a unitization situation, it did not present any question as to the tax effects of entering into a unitized project for the development of an oil and gas field. It involved the issue whether legal fees incurred in the formation of the project were deductible as ordinary and necessary business expenses.

Taxpayer's 71.87 percent unitized interest in production from the entire 64 Zone is, we submit, a separate property for depletion purposes. The Tax Court erred in holding to the contrary.

CONCLUSION

For the reasons stated, the decision of the Tax Court should be reversed.

Respectfully submitted,

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MAY, 1958.

APPENDIX A

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * *

(m) *Depletion*.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

* * * *

(26 U. S. C. 1952 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * *

(b) *Basis for Depletion*.—

* * * *

(3) *Percentage depletion for oil and gas wells*.—In the case of oil and gas wells the allowance for depletion under Section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of

the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

* * * *

(26 U. S. C. 1952 ed., Sec. 114.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.23(m)-1. DEPLETION OF MINES, OIL AND GAS WELLS, OTHER NATURAL DEPOSITS, AND TIMBER; DEPRECIATION OF IMPROVEMENTS.—

* * * *

When used in these sections (29.23(m)-1 to 29.23(m)-28, inclusive) covering depletion and depreciation—

* * * *

(b) A “mineral property” is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction. The value of a mineral property is the combined value of its component parts.

(c) The term “mineral deposit” refers to minerals in place. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

* * * *

(i) "The property," as used in section 114 (b) (2), (3), and (4) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the interest owned by the taxpayer in any mineral property. The taxpayer's interest in each separate mineral property is a separate "property"; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single "property," provided such treatment is consistently followed.

APPENDIX B

EXHIBIT 3-C

Unit Agreement For the 64 Zone Of the North Belridge
Oil and Gas Field, Kern County, California

ARTICLE I

Definitions

Section 1. The following definitions shall apply to the following terms as employed in this agreement:

* * * *

(c) UNITIZED SUBSTANCES shall mean all oil, gas and associated hydrocarbons produced and saved from the 64 Zone pursuant to this agreement.

* * * *

(e) PARTICIPANT shall mean an owner at the date of this agreement, and each successor, assignee or transferee of such owner, of the right to develop and operate lands within the Area and to produce Unitized Substances, whether as lessee or otherwise, and shall include the owner of such lands not under lease as well as the lessee of such lands under lease.

* * * *

(g) TRACT VALUE shall mean that percentage which is the share of the Unitized Substances allocated under this agreement to each respective tract of land within the Area.

(h) PARTICIPATING EQUITY shall mean that percentage which is the share of the Unitized Substances allocated under this agreement to each respective Participant.

(i) OPERATOR shall mean the person, firm or corporation selected as provided in this agreement to act as operator for Participants under this agreement, including not only the original Operator named in this agreement but each and every successor Operator selected as provided in this agreement.

(j) UNIT OPERATION shall mean the development and operation of the 64 Zone pursuant to this agreement and the conduct of such other operations as herein provided for.

(k) UNIT WELLS shall mean all wells (except wells drilled for the purpose of producing water only) in the possession of Operator under this agreement, whether acquired from Participants or drilled by Operator, and shall include necessary equipment, valves and controls for the operation thereof up to, but not including, the flow line connections of such wells and shall not include any well derricks.

(l) UNIT FACILITIES shall mean all pipe lines, crude oil flow lines, flow line connections, gage tanks, crude oil storage facilities, gas injection lines from the discharge outlet of the Compressor Plant, pumps, pumping equipment and other tangible property (except Unitized Substances, Unit Wells, rented equipment and Operator's exclusively owned equipment) of every kind, nature and description in the possession of Operator under this agreement, whether acquired from Participants or purchased or constructed by Operator pursuant to this agreement.

ARTICLE II

Unitization-Conservation

Section 1. The rights of Participants to develop and operate in and to produce from the 64 Zone oil, gas and associated hydrocarbons, and the oil, gas and associated hydrocarbons in the 64 Zone and produced therefrom, are hereby unitized, to the end that the 64 Zone shall be developed and operated as a unit by a single operator for the benefit of Participants. The Tract Values set forth in the table attached hereto marked Exhibit "B" are hereby allocated to the respective tracts of land shown therein. The Participating Equities set forth in the table attached hereto marked Exhibit "C" are hereby allocated to the respective Participants. The aggregate Tract Values of the lands of each Participant shall be equal, at all times, to the Participating Equity of such Participant, the aggregate Tract Values of all Participants shall be equal, at all times, to one hundred per cent (100%), and the aggregate Participating Equities of all Participants shall be equal, at all times, to one hundred per cent (100%).

Section 2. Operations hereunder shall be conducted in accordance with sound and efficient oil-field practices for the purpose of properly conserving the natural resources of the 64 Zone and endeavoring to obtain ultimately the maximum economic recovery of Unitized Substances.

Section 3. Except as provided in Articles IX and X hereof this agreement shall not apply to interests, rights or obligations in any formation, zone or stratum other than the 64 Zone. Each Participant reserves whatever rights it may have to develop and produce oil, gas, and associated hydrocarbons from any and all formations, zones or strata other than

the 64 Zone, and, subject to the provisions of Section 4 of Article IX hereof, the right to drill through the 64 Zone for the purpose of developing and producing from such other formations, zones and strata as lie below the 64 Zone. Each Participant also reserves whatever rights it may have to use and occupy the lands of such Participant in the Area for all purposes not inconsistent with this agreement. Any Participant exercising such rights mentioned in this Section 3 and Operator shall so conduct their respective operations as to interfere as little as practicable with the operations of the other. Each Participant also reserves the right, if such exists, to develop and produce, for its own account, water from its lands, in common with Operator.

ARTICLE III

Administration of Unit Operation

* * * *

Section 3. Participants have the right and power to and shall:

(a) Decide all matters relating to removal of any Operator and selection of any successor Operator.

(b) Determine the wells completed in the 64 Zone which are not required for the Unit Operation, pursuant to Section 2 of Article V.

(c) Determine the equipment and facilities which are or will be required for the Unit Operation, pursuant to Section 3 of Article V.

(d) Approve and adopt rearrangements or revisions of Exhibit "B" or Exhibit "C", or both, to the extent required or permitted by Section 4 of Article VII or by Article XI.

(e) Determine whether, when, how and where to drill additional Unit Wells.

(f) Determine all matters relating to major repair and maintenance of, and remedial work upon, Unit Wells, including dual zone wells.

(g) Determine all matters relating to the nature, size, location and method of operation of crude oil storage facilities and other arrangements for handling crude oil produced from the 64 Zone.

(h) Determine all matters relating to abandonment and dismantling of Unit Wells and Unit Facilities.

(i) Determine, at any time and from time to time, the measures which shall be adopted in order to endeavor to obtain ultimately the maximum economic recovery of Unitized Substances.

(j) Determine a plan and method for the control of pressure in the 64 Zone.

(k) Determine, from time to time, whether gas, water, and/or other substances shall be injected into the 64 Zone and the conditions and methods of injection, including the quantities thereof required to be injected to control pressure in such zone; and, if acquisition of additional gas, water, or other substances is determined to be advisable at any time for control of pressure, determine the amounts to be acquired and the terms and conditions upon which Operator shall be authorized to acquire and inject such additional gas, water, or other substances.

(l) Determine the Unit Wells which shall be used for injection purposes.

(m) Determine, on the basis of sound and efficient oil-field practices, rates of production of Unitized Substances.

(n) Determine the method of division of Unitized Substances among Participants in accordance with their Participating Equities in such manner that each Participant shall receive currently Unitized Substances of like quality and value as those received by each other Participant, and, to the extent that it is impracticable to make such division, determine a method for making periodic adjustments to equalize the division thereof among Participants as aforesaid.

(o) Approve or disapprove (1) Operator's estimates of costs and expenditures as provided in Section 10 of Article IV, and (2) any proposed expenditure of Operator (except those made pursuant to Section 7 or 9 of Article IV) for any item in excess of Fifteen Thousand Dollars (\$15,000.00).

(p) Approve or disapprove the proposed sale or disposition of surplus Unit Facilities.

(q) Compromise or otherwise effect settlements of material overages and shortages at time of inventories.

(r) Determine the frequency, form and nature of reports to be prepared by Operator and submitted to Participants, in addition to those provided for in this agreement.

(s) Determine any other or additional matter required by any provision of this agreement or necessary or proper in accomplishing the objects and purposes of this agreement; provided that no determination under this Section 3 shall be made contrary to the provisions of this agreement.

ARTICLE V

Transfers of Operating Rights and Other Property

Section 1. The initial Participants collectively are the owners on the date of this agreement of the right to develop and operate all lands within the Area and to produce Unitized Substances, and are the initial signatory parties to this agreement (exclusive of any exhibit hereto). At the effective time of this agreement Operator shall take exclusive possession of the operating rights of each Participant in and to the 64 Zone and enter into the performance of its duties hereunder; subject, however, to the right of each Participant to use and occupy its lands within the Area pursuant to Section 3 of Article II.

* * * *

Section 8. To the extent hereinafter in this Section 8 specified, each Participant indemnifies and agrees to hold harmless Operator and each other Participant from all loss, cost, or damage sustained by them, or any of them, as a result of any failure of title of such Participant to all or any portion of such Participant's right at the effective time of this agreement to develop and operate its lands or any thereof within the Area and to produce Unitized Substances, free and clear of the adverse interest of any person whomsoever. Such indemnity shall be limited to the amount of money Participants and/or Operator are obligated to pay and do pay to true owners of the right to produce oil, gas, natural gasoline, and associated hydrocarbons from the 64 Zone of such land as to which title has so failed, on account of such products actually produced in the course of the Unit Operation from wells located on such land, together with all costs and expenses, including reasonable attorneys' fees, incurred by Participants and/or Oper-

ator in connection with the defense against any such failure of title or claim thereof.

* * * *

ARTICLE VII

Ownership of Unitized Substances, Unit Wells and Unit Facilities; Participation; Payment of Costs and Expenses

Section 1. Each Participant shall own the percentage of Unitized Substances equal to the Participating Equity of such Participant.

Section 2. The Participants shall own, as tenants in common, all Unit Wells and Unit Facilities, and each Participant shall own an undivided interest in the Unit Wells and Unit Facilities equal to the Participating Equity of such Participant.

Section 3. In the event of changes in Participating Equities pursuant to Article XI, the ownership of each Participant in Unitized Substances, Unit Wells and Unit Facilities shall change correspondingly.

Section 4. There shall be allocated, as produced, to each numbered tract of land set forth in Exhibit "B", which is subject to this agreement at the time of production, the percentage of the total Unitized Substances produced and saved equal to the then Tract Value of such tract of land; provided, however, that such Unitized Substances as are lost by shrinkage or otherwise, or are used by Operator for fuel, gas lift, control of pressure, recycling, or other Unit Operations, or are lost by shrinkage or otherwise in the processing or removal of liquid products from wet gas allocated to Participants under this agreement, shall be excluded from such allocation and shall be royalty free. If any numbered tract of land set forth in Exhibit "B" is now or hereafter becomes divided

in ownership of Unitized Substances or Royalty Interest, or both, then, in the absence of an agreement between the interested parties determining the Tract Values of each segregated portion of such tract of land, the Tract Value shall be distributed to the segregated portions of such tract of land on a surface acreage basis, or if less than an entire numbered tract of land set forth in Exhibit "B" is excluded from this agreement as provided in Section 3 of Article XI, the Tract Value to be assigned to the portion of such tract of land remaining subject to this agreement shall be determined on a surface acreage basis.

Section 5. Except only as provided in Article XI, the Participants shall have no right or power to re-determine the Participating Equities of the Participants or the Tract Value assigned to any tract of land within the Area, and such Participating Equities and Tract Values shall not be changed, by reason of depletion of Unitized Substances, encroachment of water, evidence or proof of past, present or future nonproductivity, or for any other reason or in any other manner whatsoever, but Participants may divide or consolidate interests by transfers, assignments or other dispositions thereof, as provided in Article XI.

Section 6. Except as otherwise expressly provided in Section 2 of Article IX, each Participant shall bear and pay that part equal to its Participating Equity of all costs and expenses of the Unit Operation, including, but not by way of limitation, all costs and expenses of drilling, testing, completing, reworking, equipping and operating Unit Wells; all costs and expenses incurred in producing and saving Unitized Substances from Unit Wells; all costs and expenses incurred by Operator in planning, constructing, reconstructing, erecting, equipping, operating, main-

taining, repairing and enlarging Unit Facilities; and all costs and expenses of Operator authorized to be incurred by any provision of this agreement. Such costs and expenses, to the extent not paid in advance, shall be paid within twenty (20) days after receipt of statement from Operator, and, if not so paid, shall bear interest at the rate of seven per cent (7%) per annum. All such costs and expenses shall be accounted for in accordance with the Accounting Procedure.

ARTICLE VIII

Disposition of Unitized Substances

Section 1. Each Participant shall accept its share of the Unitized Substances (other than gas or other Unitized Substances used for injection or in operations hereunder) currently in kind as provided in this Article VIII.

Section 2. Each Participant shall take in kind its Participating Equity share of the crude oil produced and saved from the 64 Zone and delivered into the crude oil storage facilities and shall make all necessary arrangements with Operator to accept and shall accept delivery thereof from time to time upon demand of Operator. Such arrangements shall include a provision for the reimbursement of Operator for the cost of any service performed by Operator at the request of such Participant in connection with such delivery of crude oil. All crude oil shall, insofar as practicable, be divided among Participants in such manner that each Participant shall receive currently crude oil of like gravity and quality to that received by each other Participant; and, to the extent that such division is impracticable, a method for making periodic adjustments to equalize the division of crude oil among Participants as aforesaid shall be deter-

mined by Participants and placed in active operation by Operator.

* * * *

ARTICLE IX

Development of Other Zones; Default Notices

Section 1. Each Participant shall perform each and all the terms, covenants and conditions of any lease or other instrument under which such Participant is granted the right to develop and operate lands within the Area and to produce oil, gas, natural gasoline and associated hydrocarbons, insofar as such terms, covenants and conditions do not relate to the 64 Zone, to the end that no default by any such Participant in the performance of such terms, covenants and conditions not relating to the 64 Zone shall adversely affect in any way or jeopardize the rights of Operator and Participants with respect to the 64 Zone.

Section 2. In the event any Participant shall receive from the owner of any Royalty Interest any notice of default in the performance of any term, covenant or condition of any lease or other instrument under which such Participant is granted the right to develop and operate lands within the Area and to produce Unitized Substances, such Participant will forthwith furnish Operator with a copy of such notice of default and Operator shall, within five (5) days after receipt by Operator of such notice, call a meeting of Participants to consider the action, if any, Operator shall be instructed to take to protect the Unit Operation from any loss by forfeiture or otherwise on account of such default. Participants shall with reasonable promptness determine what, if any, action Operator shall take with respect to such default and shall instruct Operator accordingly. Operator shall have full right to perform any instruc-

tions given by Participants as aforesaid, even though such instructions may provide for operations relative to a zone other than the 64 Zone, and on property in which operating rights are held by a Participant who disapproves the instructions given Operator. No action taken by Participants with respect to any notice of default shall release or relieve any defaulting Participant from its obligation hereunder to perform, with respect to formations, zones or strata other than the 64 Zone, the terms, covenants and conditions of such lease, operating agreement or other instrument. Any expenditure authorized by Participants to be made by Operator pursuant to this Section 2, if and to the extent necessitated by a default of a Participant as to a matter not chargeable to the common account, shall be charged by Operator to the defaulting Participant and shall be paid by it on demand, together with interest thereon at the rate of seven per cent (7%) per annum from the date of expenditure by Operator. Operator shall have all rights and remedies for the collection from such Participant of such moneys as are provided elsewhere in this agreement for the collection of any moneys from any Participant, including the right to contribution from other Participants.

Section 3. Any Participant shall have the right, at any time, without consulting any other Participant, to surrender and quitclaim any interest held by it in and to lands within the Area other than (a) the right to drill for, develop and produce Unitized Substances, or any thereof, and (b) such surface and other rights and interests as are necessary or convenient to the Unit Operation.

Section 4. Each Participant shall have the right, as provided in Section 3 of Article II, to develop and produce for its own account oil, gas, natural gasoline

and associated hydrocarbons from any and all formations, zones or strata other than the 64 Zone. Any Participant drilling any well through the 64 Zone, or deepening, abandoning, plugging back or completing any well which has been drilled through the 64 Zone, shall take such steps as shall be designated by Participants for the purpose of protecting the 64 Zone. If the Participant conducting such operation is not willing to adopt the specific measures designated by Participants therefor, the protective measures proposed by Participants and those proposed by the Participant conducting such operations shall be referred to the Division of Oil and Gas of the Department of Natural Resources of the State of California, and the decision of that Division shall be conclusive of the matter.

* * * *

ARTICLE X

Payment of Rentals, Royalties and Taxes

Section 1. Each Participant shall pay all rentals, royalties, overriding royalties, and other payments which pertain to or affect lands of such Participant subject to this agreement, including the 64 Zone, and which may be or become payable pursuant to any lease, operating agreement or other instrument to which such Participant is a party by privity of contract or privity of estate, and each Participant shall promptly furnish to Operator, upon demand, a statement that payment thereof has been made. In the event any Participant shall fail to make payment when due of such rentals, royalties, overriding royalties and other payments, and if such failure shall constitute a default permitting termination or forfeiture of the right of such Participant in and to the 64 Zone, Operator may, if it so elects, make such

payment for and on behalf of the defaulting Participant; and Operator shall be entitled to reimbursement therefor from such defaulting Participant, together with interest on any payment so made at the rate of seven percent (7%) per annum from date of payment. Operator shall have all rights and remedies for the collection of such moneys from such Participant as are provided elsewhere in this agreement for the collection of any other moneys from any Participant, including the right to contribution from other Participants. The right of Operator to make any such payment shall be in addition to any and all other rights of Operator pursuant to the other provisions of this agreement.

Section 2. For the tax year 1950-1951 and for each tax year thereafter, each Participant shall prepare and file its returns with the proper taxing authorities covering all real estate (including improvements and mining rights or mineral interests) and personal property owned by it within the Area, excluding, however, Unit Wells and Unit Facilities, and shall pay or cause to be paid the taxes thereon. Each Participant shall furnish to the Operator a statement showing the amount of such payments, supported by copies of tax receipts. Operator shall ascertain the aggregate amount of taxes paid by all Participants with respect to the mining rights or mineral interests in the 64 Zone, provided, however, that if a part of such taxes shall have been assessed to and paid by the holder of a royalty interest, the amount thereof shall, for the purpose of the statement and apportionment hereinafter provided for, be deemed to have been paid by the corresponding Participant. The aggregate amount thereof shall be apportioned among the Participants in proportion to the respective Participating Equities on the assess-

ment date (now being the first Monday in March) for the fiscal year for which said taxes were levied and Operator shall furnish each Participant with a statement showing the amount of such taxes paid by each Participant, the aggregate amount thereof, and the apportionment thereof among Participants. Each Participant who has paid less than the amount apportioned to it shall pay the difference to the Operator, who shall ratably distribute said payment among those Participants who have paid more than the amounts apportioned to them respectively. If said taxes on the mining rights or mineral interests with respect to the 64 Zone are not separately assessed, the Participants shall determine the aggregate amount of the taxes with respect to the mining rights or mineral interests to be allocated to the 64 Zone and such determination shall be the basis for the apportionment provided for in this Section 2. If any Participant fails to make payment of its said taxes with respect to such mining rights or mineral interests, Operator may, if it so elects, make such payment for and on behalf of the defaulting Participant; and Operator shall be entitled to reimbursement therefor from such defaulting Participant, together with interest on any payment so made at the rate of seven per cent (7%) per annum from the date of payment. Operator shall have all rights and remedies for the collection of such moneys from such Participant as are provided elsewhere in this agreement for the collection of any other moneys from any Participant, including the right to contribution from other Participants. The right of Operator to make any such payment shall be in addition to any and all other rights of Operator pursuant to the other provisions of this agreement. Operator shall prepare and file returns with the proper

taxing authorities covering all Unit Wells and Unit Facilities, and Operator shall pay, or cause to be paid, to the proper taxing authorities all taxes levied or assessed against such Unit Wells and Unit Facilities and shall charge such payment to the common account. Operator shall pay all taxes and assessments on or measured by the production of Unitized Substances, including the State Petroleum and Gas Fund assessment, and shall charge such payment or payments to the common amount. The several Participants may collect from the owners of the royalty interests in their lands, by deductions from royalties or otherwise, the share of such taxes for which the owners of such royalty interests are or may be liable under any lease or other instrument without accounting therefor to the Operator or to the other Participants.

ARTICLE XI

Assignments and Transfers; Rearrangement or Revision of Tract Values and Participating Equities

Section 1. Each Participant shall retain the right at any time or from time to time to sell, assign, transfer, quitclaim, surrender or otherwise dispose of, subject to this agreement, its interests, or any thereof, in whole or in part, in or to the lands or any thereof of such Participant in the Area and in or to the Unit Wells and Unit Facilities, provided that no interest in lands with respect to the 64 Zone shall be transferred or surrendered separate from a corresponding interest in Unit Wells and Unit Facilities, or vice versa. If an interest in lands with respect to the 64 Zone shall be transeferred or surrendered, the transferee or person receiving such sur-

render shall be and become one of the Participants under this agreement, and it shall be made a condition of any such transfer or surrender that the transferee or person receiving such surrender or assignment assume in writing, filed with the Operator, all obligations and liabilities hereunder of the transferring or surrendering Participant with respect to the interest transferred or surrendered arising out of or relating to or dependent upon events occurring after the time of such transfer or surrender, and upon the filing of such assumption the Participant so transferring or surrendering such interest shall ipso facto be released and discharged from all such obligations and liabilities so assumed, but shall not thereby be released from obligations and liabilities, if any, under this agreement other than those arising out of or relating to or dependent upon events occurring after the time of such transfer or surrender. No Participant shall surrender or quitclaim any right, title or interest of such Participant in or to the 64 Zone in such a manner or under such circumstances that the tract or tracts of land to be surrendered or quitclaimed shall not remain subject to this agreement following such surrender or quitclaim.

* * * *

ARTICLE XII

Effective Time and Duration

* * * *

Section 2. This agreement, upon becoming effective as provided in Section 1 of this Article XII, shall continue in full force and effect as long as Unitized Substances, or any of them, can be produced from the 64 Zone in quantities determined by Participants to be sufficient to pay to produce; provided, however,

that this agreement may be terminated prior to such expiration date by the unanimous consent of all Participants.

* * * *

ARTICLE XIII

Miscellaneous

* * * *

Section 2. Each Participant, to the extent of such Participant's Participating Equity share thereof, indemnifies and agrees to hold each other Participant harmless of and from any claim of or liability to any third person asserted upon the ground that operations under this agreement have resulted in or will result in any loss or damage to such third person, to the extent, but only to the extent, that such claim or liability is asserted against such other Participant in an amount in excess of such other Participant's Participating Equity share of such claim or liability; it being the intention of Participants that any claim of or liability to any third person asserted upon the ground that operations under this agreement have resulted in, or will result in, any loss or damage to such third person, shall be borne by all Participants in proportion to their respective Participating Equities. The indemnity provided by this Section 2 shall also cover all costs and expenses, including reasonable attorney's fees, incurred by any Participant in connection with any such claim of or liability to any third person. At the request of any Participant, Operator shall effect collection of the indemnity provided for by this Section 2 from all Participants liable under such indemnity; and Operator shall have all rights and remedies for the collection thereof which are provided elsewhere in this agreement for the collection of other moneys from

any Participant, including the right to contribution from other Participants. Neither the indemnity contained in this Section 2 nor that contained in Section 8 of Article V shall impair the other, and such indemnities, where both are applicable, shall be considered together.

* * * *

Section 9. Each Participant hereby waives the benefit of the provisions of Chapter IV, Title X, Part II of the Code of Civil Procedure of the State of California relating to actions for partition of real and personal property and does hereby covenant with each other Participant that during the existence of this agreement such Participant will not at any time resort to any action at law or in equity to partition the property, or any thereof, owned by Participants as tenants in common pursuant to this agreement.

* * * *

APPENDIX C

Table of Exhibits Pursuant to Rule 18(2)(F) as Amended:

<i>Exhibits</i>	<i>Identified, Offered and received</i>
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No. 15887

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

BELRIDGE OIL COMPANY,

Respondent.

BRIEF FOR THE RESPONDENT.

With Appendices.

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FILED
JUN 24 1958
PAUL P. O'BRIEN, CLERK

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No. 15887

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

BELRIDGE OIL COMPANY,

Respondent.

BRIEF FOR THE RESPONDENT.

With Appendices.

Opinion Below.

The opinion and findings of the Tax Court of the United States in the case below [R. 79-104] are reported in 27 T. C. 1044.

Jurisdiction.

The Petition for Review was taken pursuant to the provisions of Section 7483 of the *Internal Revenue Code of 1954*, and jurisdiction is conferred on the Court by Section 7482 of the 1954 Code.

The proceeding involves Federal internal revenue taxes, for the taxable year ended December 31, 1950, in the form of corporate income and excess profits taxes under the provisions of Chapter 1 of the *Internal Revenue Code of 1939*. The respondent was and is a California cor-

poration with its principal office in Los Angeles, California, and it filed its income and excess profits tax return for the year 1950 with the internal revenue office in and for the Los Angeles, California, district [R. 38], which office and district is located within the jurisdiction of the United States Court of Appeals for the Ninth Circuit.

On May 28, 1954, the Commissioner of Internal Revenue mailed to the respondent the statutory notice of determination of deficiencies in income tax (\$33,879.44) and excess profits tax (\$9,866.88) for the taxable year 1950 [R. 38]. On August 18, 1954 (a date within ninety days of the mailing of the deficiency determinations), the respondent filed a petition in the Tax Court of the United States seeking a redetermination of the asserted tax deficiencies [R. 3, 5-20]. Jurisdiction of said petition was conferred in the Tax Court by Section 6213(a) of the *Internal Revenue Code of 1954* (which continued, substantially unchanged, the provisions of Sec. 272(a) of the 1939 Code). On July 26, 1957, the Tax Court entered its decision that a deficiency in income tax, for the year 1950, in the amount of \$1,246.97, existed against the respondent [R. 112].

The case is brought to this Court by a Petition for Review, filed by the Commissioner of Internal Revenue on October 18, 1957 [R. 113-117] pursuant to the provisions of Sections 7482 and 7483 of the *Internal Revenue Code of 1954*.

Questions Presented.

Did the Tax Court of the United States grant to the respondent a greater allowance for the depletion of oil and gas wells than it is entitled to under Sections 23(m) and 114(b)(3) of the *Internal Revenue Code of 1939*?

Statutes and Regulations Involved.

The pertinent statutes and regulations involved are reproduced, in material part, in the Appendix A, *infra*.

Sections of the Internal Revenue Code of 1939, referred to herein, are reported in Title 26, U. S. C. A., Internal Revenue Code of 1939, as amended; and sections of the Internal Revenue Code of 1954 are reported in Title 26, U. S. C. A., Internal Revenue Code.

The sections of the United States Treasury Department Regulations 111, referred to herein, are reported in 26 C. F. R., 1949 Edition.

Statement of the Case.

With respect to oil and gas properties, Sections 23(m) and 114(b)(3) of the Internal Revenue Code of 1939 (App. A, *infra*) and the United States Treasury Department Regulations applicable thereto (Reg. 111, Secs. 29.23(m)-1, 29.23(m)-2 and 29.23(m)-4, App. A, *infra*) provide, in substance, that in computing taxable net income, a taxpayer who owns an economic interest in a mineral deposit shall be allowed an annual deduction for a reasonable allowance for the depletion of the oil and gas "property." The Code and Regulations provide that the allowable deduction for depletion shall be computed on the basis of percentage depletion or cost depletion, whichever of the two methods results in the greater deduction; and that the computation shall be made separately for each oil and gas "property." "Percentage depletion" is an amount equal to 27½% of the gross income from the "property" during the taxable year, but "percentage depletion" for any one year cannot exceed 50% of the net income of the taxpayer (computed without allowance for depletion) from the "property." "Cost

depletion" is computed as follows: The "number of units remaining" (that is, the number of recoverable barrels of oil, etc., remaining in the ground) is estimated as of the end of the taxable year. The estimated "number of units remaining" is divided into the adjusted cost (or other adjusted basis for computing gain) of the mineral property, and this gives the "depletion unit" expressed in terms of money. The depletion unit, so determined, is multiplied by the number of units of mineral *sold* (not the number of units produced) during the taxable year, and the result is the amount of "cost depletion" allowable.

The above-cited provisions of the 1939 Code and the applicable Treasury regulations (1939 Code, Secs. 114(b)(3), 23(m); Reg. 111, Secs. 29.33(m)-4, 29.23(m)-1, 29.23(m)-2; App. A, *infra*) provide that "in no case" shall the allowable depletion deduction be less than the amount of cost depletion, which means that in the case of each mineral "property" the allowable deduction for depletion is *always* the greater of either cost depletion or percentage depletion. This fundamental point is one of considerable importance in the determination of this proceeding.

Prior to and during the tax year 1950 (the year at issue), the respondent, Belridge Oil Company, was the owner of two oil and gas "properties" in Kern County, California, which are referred to in the proceedings below and will be referred to herein, as the "Main Property" and the "Result Property." The Main Property (consisting of 30,845.96 acres) was acquired in 1911, and it encompasses portions of two separate oil and gas producing fields, the North Belridge Field and the South Belridge Field. Production from the North Belridge Field is obtained from five separate zones or pools, one

of which is a relatively shallow zone, and the other four are at the approximate depths of 6,000, 7,000, 8,000 and 9,000 feet, respectively. The zone or pool at the 8,000-foot depth is called the 64 Zone; and the zone or pool at the 6,000-foot depth is called the Temblor Zone. The respondent's Result Property (consisting of 80 acres) was acquired as of September 1, 1944, and it encompasses portions of the 64 Zone and the Temblor Zone of the North Belridge Field.

In addition to underlying portions of the respondent's Main and Result properties, the 64 Zone of the North Belridge field underlies portions of properties owned or leased by five other oil companies. Prior to October of 1941, production by the respondent and the other five oil companies from the 64 Zone was on a competitive basis, which resulted in a marked decrease in reservoir pressure and overall oil production. From October, 1941, to April 1, 1947, a voluntary gas pressure maintenance program was put into effect by the six companies, and a portion of the gas produced from the 64 Zone was returned to the Zone to maintain reservoir pressure. However, in April of 1947, the six companies producing from the 64 Zone abandoned their program of voluntary pressure maintenance, and resumed unrestricted competitive production, which continued up to February 1, 1950.

As of February 1, 1950, the respondent and the five other oil companies producing from the 64 Zone entered into an agreement (entitled "Unit Agreement for the 64 Zone of the North Belridge Oil and Gas Field, Kern County, California") for the production of oil and gas on a cooperative basis "to the end that the 64 Zone shall be developed and operated as a unit by a single operator for the benefit of the Participants." (Four extra copies

of the Unit Agreement [Tax Court Ex. 3-C] have been lodged with the Clerk of the Court; and, in the interests of economy, the agreement will not be reproduced in this brief.)

In the Unit Agreement, the respondent was named as the "Operator"; and each of the six parties to the agreement, as an owner of a right to develop, operate and produce in the 64 Zone, transferred the exclusive possession of its "operating rights" to the respondent, as Operator, with the stated intention "to establish Operator as its agent under this agreement, for the sole purpose of developing, operating, and protecting its interest in the 64 Zone to the extent herein set forth." Under the Unit Agreement each of the Participants was allotted a "participating equity," expressed in terms of a percentage, of the oil, etc., produced and saved from the 64 Zone by the Operator; and each Participant took its share of the production in kind. The respondent's participating equity was 71.87%, and this participation, as well as the participations of the other five parties, approximated the same percentages of total production from the 64 Zone which the several parties had achieved during the period of unrestricted competitive production which had continued from April of 1947 to the effective date of the Unit Agreement, February 1, 1950.

In prior years and up to and including the month of January of the year at issue (1950), both the respondent and the Commissioner of Internal Revenue had consistently treated the Main Property (inclusive of the North and South Belridge fields and of the five zones of the North Belridge Field, to the extent such fields and zones were under the Main Property) as one mineral "property" for depletion deduction purposes. This procedure

is authorized by United States Treasury Department Regulations 111, Section 29.23(m)-1(i) (App. A., *infra*), and see also *Island Creek Coal Company* (1958), 30 T. C., No. 35. Similarly, in prior years and up to and including the month of January of the year at issue, both the respondent and the Commissioner had consistently treated the Result Property (including the 64 Zone and the Temblor Zone underlying it) as one mineral "property," and as a property separate from the respondent's Main Property, for depletion deduction purposes.

On its 1950 tax return, the respondent computed and claimed separate depletion deductions for its Main and Result Properties. As in past years, the respondent regarded the 64 Zone underlying its Main Property as being part of the Main Property; and the respondent regarded the 64 Zone underlying its Result Property as being part of its Result Property. The depletion deduction claimed with respect to Main Property was based on percentage depletion, which was greater than cost depletion, since the respondent had fully recovered its cost of the Main Property in prior years. The depletion deduction claimed with respect to the Result Property was based on cost depletion, which was greater than percentage depletion, in the case of the Result Property.

As the basis of his determination of tax deficiencies for the year 1950, the Commissioner conceded that, for the month of January, 1950, the respondent's Main Property (inclusive of the 64 Zone) was a separate property for depletion purposes, with respect to which percentage depletion was allowable; and that, for the month of January, the respondent's Result Property (inclusive of the 64 Zone) was a separate property for depletion purposes,

with respect to which cost depletion was allowable. However, for the eleven-month period in 1950 after the effective date of the Unit Agreement (February 1, 1950), the Commissioner claimed that the respondent had three separate and altered properties for depletion purposes, on the theory that, as of the effective date of the Unit Agreement, the respondent severed the 64 Zone portions of its Main and Result properties from the remainder of said mineral properties, and then, within the meaning of Sections 112(b)(1) and 113(a)(6) of the 1939 Code (App. A, *infra*), it made a tax-free exchange of the two severed 64 Zone portions for a new and separate depletable property in the form of a 71.87% share of the oil, etc., produced by itself as Operator under the Unit Agreement. The effect of the Commissioner's severance and tax-free exchange theory is as follows:

Month of January, 1950:

Respondent had two separate depletable properties:

- No. 1. The Main Property, inclusive of the 64 Zone and the other four zones underlying the property.
- No. 2. The Result Property, inclusive of the 64 Zone and the Temblor Zone underlying it.

February to December, 1950:

Respondent had three separate depletable properties:

- No. 1. The Main Property, excluding the 64 Zone but including the other four zones underlying it.
- No. 2. The Result Property, excluding the 64 Zone, but including the Temblor Zone underlying it.

- No. 3. A new depletable property consisting of 71.87% of the production from the 64 Zone under the Unit Agreement.

The results of the Commissioner's theory and determination were deficiencies in income and excess profits taxes for the year 1950, arising from the following procedures and adjustments:

1. For the month of January, 1950, the Commissioner recognized that the 64 Zone underlying the Main Property was part of said property for the purpose of computing the allowable percentage depletion deduction.

2. For the month of January, 1950, the Commissioner recognized that the 64 Zone underlying the Result Property was part of said property for the purpose of computing the allowable cost depletion deduction.

3. For the eleven-month period February to December, 1950, the Commissioner disallowed the cost depletion deduction which the respondent had claimed with respect to its Result Property.

4. For said eleven-month period, the Commissioner reduced in amount the percentage depletion deduction which the respondent had claimed with respect to its Main Property.

5. For said eleven-month period the Commissioner computed and allowed a deduction for percentage depletion (limited to 50% of the net income, computed without depletion, from the property) with respect to the respondent's 71.87% share of production under the Unit Agreement.

6. Although required by the statute and his regulations, the Commissioner *made no attempt to compute cost depletion* applicable to the respondent's 71.87% share of production under the Unit Agreement.

The Tax Court of the United States rejected the Commissioner's determination that the respondent, as of the date of the Unit Agreement (February 1, 1950), effected a severance and tax-free exchange of the 64 Zones underlying its Main and Result properties for a new and separately depletable property in the form of respondent's 71.87% of the oil, etc., produced and saved by it, as Operator, under the Unit Agreement. And the Tax Court agreed with the respondent that, both before and after the effective date of the Unit Agreement, the respondent was possessed of two separate depletable mineral properties; namely, its Main Property, inclusive of the 64 Zone underlying it, and its Result Property, inclusive of the 64 Zone underlying it. The Tax Court revised the respondent's computation of the allowable depletion [R. 104-112] and (based on miscellaneous adjustments made by the Commissioner in his deficiency notice which are not at issue in this case) the Tax Court determined that there is a deficiency in income tax for the year 1950 in the amount of \$1,246.97 [R. 112]. The respondent accepts said determination of income tax deficiency, and it has paid the deficiency, together with interest thereon.

The Tax Court determined (1) that the Unit Agreement contains no words of conveyance or exchange of depletable interests; (2) that there was no intention on the part of the parties to the Unit Agreement to convey or exchange their interests in the 64 Zone; and (3) that the net effect of the Unit Agreement was nothing more

than a joint effort on the part of the owners of the producing rights in the 64 Zone to best conserve their respective individual interests by joining in a plan for the most economical and productive operation of the Zone; and that each Participant had the same essential rights and interests in its respective property after the Unit Agreement as before, except that, by mutual consent, they had agreed to limit their production, and to operate their wells in the most economically feasible way, from the standpoint of conservation considerations [R. 79-104].

The Commissioner, in his Petition for Review [R. 113, 115-116], *concedes* the Tax Court determinations which are labeled (1) and (2) in the preceding paragraph. That is, the Commissioner concedes, in his Petition for Review, that the Unit Agreement contains “no words of conveyance” of the 64 Zone properties, and that “there was no expressed intention on the part of the participants to convey or exchange their economic interest in the Zone” [R. 115-116].

The Commissioner contended, in his Petition for Review, that the “practical consequence of the transaction . . . was the same as though formal contracts of exchange had been executed,” and he stated the issue presented for review as follows:

“Whether the Tax Court erroneously held that by joining in a unitization agreement for the cooperative operation of all the wells in a certain oil pool, taxpayer did not *exchange* its separate depletable interest in two oil properties covered by the agreement for a new depletable interest” [R. 115-116; italics supplied.]

However, in his Brief for the Petitioner, the Commissioner now states he is *abandoning* the “exchange” theory

ARGUMENT.

I.

The Petitioner Has Abandoned the Theory Upon Which the Case Was Pleaded, Tried, and Decided in the Tax Court, and the Petitioner's New Theory on Appeal Would Require Determinations of Fact, With Respect to Which No Evidence Was Ad-duced in the Trial Court; Therefore, the New Theory Should Not Be Considered on Appeal.

In its opinion, the Tax Court stated the main issue for decision as follows [R. 81; italics supplied]:

“(1) Whether, by joining in a unitization agree-ment for the co-operative operation of all wells in a certain oil pool, petitioner *exchanged* its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under unitized operation; . . .”

And in his Petition for Review, the petitioner stated the issue as follows [R. 115; italics supplied]:

“The issue to be presented for review therefore is: Whether the Tax Court erroneously held that by joining in a unitization agreement for the co-operative operation of all the wells in a certain oil pool, tax-payer did not *exchange* its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under the unitized operation and is, accordingly, entitled to claim percentage de-pletion on one and cost depletion on the other as pre-viously claimed by taxpayer.”

The petitioner now states in his Brief that it is abandon-
ing the “exchange” theory for a contention that there was

a “merger” of interests; and petitioner expresses concern “(l)est taxpayer conceive our abandonment of the ‘exchange’ theory and our present argument as a new argument . . .” (Pet. Br. pp. 16-17, footnote 5). The respondent certainly does conceive and contend that the Commissioner has abandoned on appeal the only theory upon which the case was pleaded, tried, briefed, and decided in the Tax Court; and that the petitioner’s new “merger” theory is an entirely new theory of the case which cannot properly be raised on appeal, particularly since the implementation of the new theory would require determinations of fact, with respect to which no evidence was adduced in the Tax Court.

General Utilities & Operating Company v. Helvering (1935), 296 U. S. 200, 56 S. Ct. 185, 80 L. Ed. 154;

Union Pacific Railroad Company v. Johnson (9 Cir., 1957), 249 F. 2d 674;

United States v. Marshall (9 Cir., 1956), 230 F. 2d 183, 193;

Inman-Poulsen Lumber Company v. Commissioner (9 Cir., 1955), 219 F. 2d 159;

United States v. Merrill (9 Cir., 1954), 211 F. 2d 297;

United States v. Waechter (9 Cir., 1952), 195 F. 2d 963;

Bagnall v. Commissioner (9 Cir., 1938), 96 F. 2d 956;

Kottemann v. Commissioner (9 Cir., 1936), 81 F. 2d 621.

And see also:

American Bemberg Corporation v. United States of America (3 Cir., 1958), 253 F. 2d 691.

In the *General Utilities* case, *supra*, the Supreme Court determined that a point not presented to or ruled upon by the Board of Tax Appeals, and not stated in the petition for review, was not a proper subject for consideration by the appellate court; and the Supreme Court *reversed* the decision of the Court of Appeals for the Fourth Circuit which was based on the new theory. The Supreme Court said (296 U. S. at 206, 80 L. Ed. at 157):

“Always a taxpayer is entitled to know with fair certainty the basis of the claim against him. Stipulations concerning facts and any other evidence properly are accommodated to issues adequately raised.”

The language of your Honorable Court in the *Union Pacific* case, *supra*, is in a similar tone (249 F. 2d at 677):

“One of the things that ought to be certain is that parties do not find themselves trying a new and different case on each successive higher branch of the appellate tree. If this rule is observed, plaintiff and defendants in the end will profit from the certainty of the law.”

See also your decision in the case of *Kottemann*, *supra* (81 F. 2d at 622-623):

“We are first concerned with the question of whether or not petitioner is barred in this court from raising this question, not having brought the *precise point* to the attention of the Board of Tax Appeals.” (Italics supplied.)

And the Court went on to hold that:

“It is a fundamental rule of federal appellate procedure that only such points as are made in the court below or such questions as are there raised will be reviewed on appeal; and unless the questions or points have been presented to the court below, they are not before this court for review.”

The respondent has emphasized the language in the *Kottemann* case, *supra*, that the “*precise point*” must be brought to the attention of trial court, if it is to be availed of on review; and a similar ruling was made by your Honorable Court in the *Bagnall* case, *supra* (96 F. 2d at 958), where the Court pointed out that it is not enough that the disputed point “lurked in the record” below, since the appellate court may not “consider or determine any point not *pressed* before the Board of Tax Appeals or ruled upon by that body.” (Italics supplied.)

A. The Record Clearly Shows That Petitioner Has Abandoned the Theory of the Case, and Is Improperly Advancing a New Theory on Appeal.

Appendix B of this brief contains an exhaustive analysis of the record, complete with citations and quotations, which demonstrates beyond point of cavil that the petitioner’s announced “abandonment of the ‘exchange’ theory” is an unauthorized and unfair abandonment of the theory upon which the deficiency determination was asserted, and the case was pleaded, tried, and decided in the Tax Court. And in the light of the above-cited decisions of the Supreme Court and your Honorable Court, the petitioner’s new “merger” theory is not a proper subject of appellate review in this proceeding.

B. The Petitioner’s New “Merger” Theory Would Require Substantial Factual and Legal Elaboration, Not Grounded on the Record, to Sustain It; and, for That Reason Alone, Cannot Properly Be Introduced Into This Case as a New Matter on Appeal.

The statement made in the headnote to this division of respondent’s brief is amply supported by the decision of your Honorable Court in *Bagnall v. Commissioner* (9 Cir., 1938), 96 F. 2d 956, and by the recent decision of

the Third Circuit in *American Bemberg Corporation v. United States of America* (3 Cir., 1958), 253 F. 2d 691. And the petitioner's new "merger" theory, like Pandora, opens the lid on a host of troublesome problems, both legal and factual, which cannot be decided on the basis of the existing record.

Petitioner states he is abandoning the "exchange" theory, yet he contends that by some process (the precise characterization of which he claims is unnecessary) the respondent acquired a new, separate, and single depletable interest in return for its former two property interests in the 64 Zone. Certainly if this is what took place (as the petitioner asserts), it must have had tax consequences, for under Section 111 of the 1939 Code the following general rules are stated (*italics supplied*):

"(a) The gain from the sale or *other disposition* of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

"(b) The amount realized from the sale or *other disposition* of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

Although the petitioner claims that under his new "merger" theory the "(p)recise characterization of the nature of the unitization transaction as to this taxpayer is unnecessary," it is safe to assume it was not a "sale" and petitioner has expressly abandoned the contention that it was a tax-free "exchange"; therefore, the transaction, under petitioner's new theory, must fall in the "*other disposition*" category of Code Section 111, necessitating

the computation of a gain or a loss for the year at issue. In order to compute either gain or loss on the petitioner's new theory, the Court would have to know at least two things, *neither of which appears in the record*: namely, the adjusted basis of the two properties the respondent is supposed to have disposed of, and the fair market value of the new property allegedly received in return. At the trial of this case, the petitioner sought to qualify a valuation expert (Engineer Revenue Agent Roger F. White), but the witness never did place a monetary value either on the 64 Zone portion of the Result Property [the Result Property encompasses a portion of the Temblor Zone as well as a portion of the 64 Zone, R. 44-45], nor on the alleged new interest in the unitized operation [R. 68-78]. And there is nothing in the stipulation of facts covering the foregoing matters [R. 38-51], although the parties did stipulate, in effect, that the respondent had no tax basis for its Main Property 64 Zone interest [R. 43, par. 17].

We next come to another insoluble problem presented by the petitioner's new "merger" theory: What is the amount of the tax basis of the alleged new separate and single depletable unit which the respondent is supposed to have acquired? Section 113(a) of the 1939 Code states the general rule that:

"The basis of property shall be the cost of such property"

One of the exceptions to the general rule occurs in the case of tax-free exchanges (Sec. 113(a)(6) of the 1939 Code, App. A, *infra*); but since the petitioner has repudiated the "exchange" theory, the cited exception is not applicable under petitioner's new theory, and the general cost-basis rule would govern. Under the cases and the

regulations (*Estate of Myers* (1942), 1 T. C. 100 (Acq.); *MacCallum Gauge Company* (1935), 32 B. T. A. 544 (Acq.); Title 26 C. F. R., Part 1, Sec. 1.1012-1), the cost of the alleged new property acquired under the petitioner's "merger" theory would be the *fair market values* (not the adjusted tax bases) of the respondent's original interests in the 64 Zone; and the record in this case is totally devoid of any factual basis for making the necessary determination of the cost basis of the alleged new property interest.

Under the revenue codes it would be mandatory to determine the cost basis of the alleged new property interest for, as previously pointed out in this brief, Sections 114(b)(3) and 23(m) of the Code, and Sections 29.23(m)-4, 29.23(m)-1, and 29.23(m)-2 of Treasury Regulations 111 (App. A, *infra*) are specific on the point that "in no case" shall the allowance for depletion be less than the allowance based on the unit, or, cost, basis; and one obviously needs to know what the cost basis is before the necessary unit, or cost, computation can be made. See *Producers Oil Corporation* (1940), 43 B. T. A. 9, at 11, where the Board held as follows (*italics supplied*):

" . . . under the last clause of section 114(b)(3) the allowance under the percentage method may in no case be less than under the unit method. To one using the percentage method a computation by the unit method is *always necessary*, for '*in no case shall*' the allowance be less than such a computation shows. *This is mandatory.*"

Any attempt to compute the mandatory unit, or cost, depletion on the alleged new property interests would engender additional legal and factual frustrations. To illustrate, the unit, or cost, depletion computation contemplated by Treasury Regulations 111, Section 29.23(m)-2 (App. A, *infra*) can be expressed by the formula: $D = \frac{C \times P}{R}$, where “D” stands for the allowable cost

depletion deduction; “C” stands for the adjusted cost basis; “R” stands for the estimated total number of units (barrels of oil, etc.) in the ground at the end of the year; and “P” stands for the number of production units which are taken into account.

Respondent has previously demonstrated that the record contains no basis for determining factor “C” in the above formula, under the petitioner’s new theory; but neither is there any basis in the record for determining factor “R.” With respect to factor “P,” the parties have stipulated that, under the Unit Agreement, 237,062 barrels of oil were actually produced from wells located on the *surface areas* of the respondent’s Main and Result properties, and that respondent was allocated 307,704 barrels of unit production [R. 46, pars. 22, 23]. Which of these figures (237,062 or 307,704) should be used as factor “P” in the formula and why? This problem was not presented to nor passed upon by the Tax Court, and since the petitioner, on brief, is extremely critical of the sound and reasonable solution which the Tax Court arrived at in an analogous situation (see Pet. Br. pp. 19-20), it would

be interesting to know what course he advocates (and on what grounds) now that he is brought to the realization that he is faced with the same problem under his new theory on appeal. But the petitioner's brief is silent on this vital point.

Respondent could go on and multiply instances in which the petitioner's new "merger" theory would create factual and legal problems, insoluble on the basis of the existing record, but enough has been written to demonstrate the complete applicability of the salutary principle announced by your Honorable Court in an analogous case (*Bagnall v. Commissioner* (9 Cir., 1938), 96 F. 2d 956, at 958), wherein the Court stated the following:

"Once we undertake to construe and apply the trust instrument, numerous and perplexing collateral questions, some of law, others of fact, intrude themselves and demand answer—questions not ruled upon by the Board, not presented by the assignments, and discussed, if at all, only in belated and inadequate briefs . . . In reviewing orders of the Board made on petitions to redetermine assessments of deficiencies we are dealing with intricate and difficult problems inherent in the administration of a great department of the government, as well as with equally intricate provisions of the revenue laws themselves. This case illustrates as well as any the good sense of the rule which confines the courts to a review of the points presented to or ruled on by the administrative tribunal clothed by Congress with full authority to inquire into and determine disputes, both as to the law and as to the facts."

II.

In Essence, This Appeal Is From the “Decision” (as Distinguished From the “Opinion”) of the Tax Court. That Decision Is That There Is a Deficiency in Income Tax in the Amount of \$1,246.-97; and Since the Petitioner Cannot, on the Record, Show a Greater Amount of Tax Liability, the Decision of the Tax Court Must Be Affirmed.

In the preceding division of this brief the respondent has demonstrated the salutary principle that, on appeal, the decision of the trial court cannot be reversed on a theory different from the one on which the case was tried and decided. However, the appellee, and the appellate court, is *not* limited by this rule in seeking to *uphold* the decision of the trial court. That is, on an appeal from the Tax Court, the prevailing party below is entitled to the benefit of every inference which reasonably can be drawn from the evidence, viewed in the light most favorable to him and most unfavorable to the appellant, and if the *decision* of the Tax Court is correct, it must be affirmed, even though the lower court relied upon a wrong ground or gave a wrong reason.

Helvering v. Gowran (1938), 302 U. S. 238, 58 S. Ct. 154, 82 L. Ed. 224;

United Pacific Railroad Company v. Johnson (9 Cir., 1957), 249 F. 2d 674 (footnote 4 on p. 677);

Card v. Commissioner (8 Cir., 1954), 216 F. 2d 93, at 96-97;

Wheeler v. Holland (5 Cir., 1955), 218 F. 2d 482;

Gulf, Mobile & Ohio R. Co. v. Williamson (8 Cir., 1950), 191 F. 2d 887, at 893.

Under the applicable statute (Sec. 7482 of the *Internal Revenue Code of 1954*) your Honorable Court is granted jurisdiction to review the *decision* of the Tax Court. The decision in this case is [R. 112]:

“That there is a deficiency in income tax for the taxable year 1950 in the amount of \$1,246.97.”

The word “deficiency” is defined by law to mean “(t)he amount by which the tax imposed by this chapter exceeds the amount shown as the tax by the taxpayer upon his return (Sec. 271, *Internal Revenue Code of 1939*, and see Sec. 6211, 1954 Code). In other words, “a deficiency consists, not of a theory or a method of computation, but of a sum of money representing the difference between what the taxpayer’s return discloses and what the law in fact imposes on him under the actual circumstances.” (*Veeder v. Commissioner* (7 Cir., 1927), 36 F. 2d 342.)

It is, therefore, elemental that the petitioner here cannot show that the *decision* of the Tax Court is wrong unless he can affirmatively demonstrate what he considers to be the correct amount of the tax for the year at issue. And petitioner cannot do this, either under his new “merger” theory or under his abandoned “exchange” theory, because there is absent from the record the required factual basis for making the necessary computation or computations.

Enough has been said in division I-B of this brief to demonstrate that the petitioner has not made a record sufficient to support *any* tax computation under his new “merger” theory—he cannot show whether gain or loss (much less the amount of gain or loss) was realized on the alleged disposition of the old 64 Zone interests for a new interest; he cannot compute cost depletion under his new theory, although the statute makes mandatory such a computation, etc.

With respect to the petitioner's abandoned "exchange" theory, the record similarly is barren of a factual foundation to support a tax computation on the basis asserted by the petitioner. Respondent has previously demonstrated that the statute, the regulations, and the case decisions all make mandatory the computation of depletion on a cost basis, since "in no case" shall the allowance for depletion be less than depletion computed on the basis of cost (Secs. 114(b)(3) and 23(m) of the 1939 Code; Reg. 111, Secs. 29.23(m)-4; *Producers Oil Corporation* (1940), 43 B. T. A. 9, at 11). Despite this statutory requirement, the petitioner originally made his determination of deficiency without regard to cost depletion, and the Tax Court so found as a fact [R. 96]:

"No computation of cost depletion with respect to that 71.87 per cent undivided interest appears in the deficiency notice."

In an effort to overcome this obvious defect, petitioner called Engineer Revenue Agent White as a witness at the trial [R. 68-78], but the witness gave no testimony that would support a finding concerning cost basis under the petitioner's now-abandoned "exchange" theory, and the Tax Court made no such finding. Nor was any evidence adduced or finding made concerning the number of units (barrels of oil, etc.) in the reserve, under the petitioner's abandoned "exchange" theory (see Reg. 111, Sec. 29.23 (m)-2, App. A, *infra*); and a cost depletion computation cannot be made without this figure being established.

An additional reason why the petitioner is required to demonstrate a proper computation of cost, or unit, depletion in this proceeding is that the Tax Court determined, in effect, that there was *no* excess profits tax deficiency in this case [R. 112, 104-111], yet the petitioner's State-

ment of Points to Be Relied Upon advances, as a basis for review, the claim that the Tax Court erred [R. 120]:

“12. In failing to hold and decide that there is . . . a deficiency in excess profits tax of \$9,866.88.”

(This is the amount of the excess profits tax deficiency originally asserted by the petitioner.) Yet in order to make the necessary determination of invested capital, for excess profits tax computations, the allowable depletion deduction must be computed on the cost, or unit, basis, as distinguished from the percentage depletion basis (*Internal Revenue Code of 1939*, Secs. 435-441, Title 26 U. S. C. A. Excess Profits Taxes; Vol. 1 *Merten's, Law of Federal Income Taxation* (Zimet, Stanley & Kilcallen Revision) Sec. 9.33). For example, the last cited work states the following (Ch. 9, pp. 53-54):

“ . . . it is important to keep in mind that earnings and profits must be determined for two different purposes—dividend source for income tax computation and invested capital for excess profits tax computation . . . In computing total earnings and profits for the purpose of determining invested capital, depreciation and depletion must be computed on cost or other basis without regard to March 1, 1913 value. . . .

“Thus, discovery or percentage depletion as otherwise allowable for income tax purposes to operators of mines, and oil and gas wells and the like, is not to be taken into account in computing earnings and profits.”

The respondent submits that since the petitioner cannot make a proper tax computation on *any* theory, heretofore

advanced or now advanced by him in this proceeding, he cannot demonstrate that the *decision* of the Tax Court is in error. And since, on appeal, all intendments must be indulged in in favor of the correctness of that decision, it is respectfully submitted that your Honorable Court is required to affirm the decision of the Tax Court.

III.

The Tax Court Correctly Determined That the Respondent Retained the Same Interests and Rights in Its Two Separate 64 Zone Properties After Unitization as Before; and That Neither in Form nor in Substance Were the Pre-existing Rights Exchanged or Otherwise Disposed of for a New Depletable Interest.

The Tax Court stated that, in order to uphold the Commissioner's deficiency determination:

"We must find that the unitization agreement here, preferably both in form and in substance, effected an exchange; and, if not in form, certainly in substance."
[R. 99.]

And the Tax Court held that nowhere in the unitization agreement [Ex. 3-C] "do we find any words of conveyance; and, more important, we find no intention on the part of the Participants to convey or exchange their economic interests in the 64 Zone" [R. 100]. The Petition for Review *concedes these points* and confesses:

". . . there are no words of conveyance in the agreement involved . . . and there was no expressed intention on the part of the participants to convey or exchange their economic interests in the Zone . . ." [R. 115-116.]

Now, however, some eight and one-half years after the Unit Agreement went into effect, the petitioner asks your Honorable Court:

- (a) to disregard the form of the transaction;
- (b) to disregard the intentions of the Participants;
- (c) to disregard petitioner's own theory on which the deficiency was determined, the case tried, and the Petition for Review filed;
- (d) to disregard as "irrelevant" the premises upon which the Tax Court based its decision;

and to determine for the first time that the substance of the transaction was something of a different nature, although petitioner refuses to be tied down to specifics, under claim that "(p)recise characterization of the nature of the unitization transaction as to this taxpayer is unnecessary" (Pet. Op. Br. 16-17). It is respectfully submitted that to accede to the petitioner's request would discredit accepted principles of fair tax administration and proper trial and appellate procedures.

The Tax Court's determination that neither the form nor the substance of the Unit Agreement [Ex. 3-C] effected a change in depletable interests was based on sound grounds. The absence of words or forms of conveyance in the Unit Agreement is, in itself, a factor of importance, for in the case of *Usibelli v. Commissioner* (9 Cir., 1955), 229 F. 2d 539, at 543, your Honorable Court emphasized the contractual relation factor as follows:

"The question whether any given taxpayer engaged in the extractive industries has, under the facts of his particular case, a depletable interest in the mineral in place, is difficult and depends for its answer upon the various incidents of the contractual relation under which he works."

The Unit Agreement [Tax Court Ex. 3-C] is concerned with the rights of the Participants “to develop and operate in and produce from the 64 Zone oil, gas and associated hydrocarbons” [Ex. 3-C, Art. II, Sec. 1]. Article V of the Agreement is entitled “Transfer of Operating Rights and Other Property,” and the reference to “Other Property” is to *depreciable* tangible property, the transfer of which is not an issue in this case. (See *Choate v. Commissioner* (1945), 324 U. S. 1, 65 S. Ct. 469, 89 L. Ed. 653.) In regard to “operating rights,” the only “transfer” effected was made in the following language [Art. V, Sec. 1, Ex. 3-C]:

“At the effective time of this agreement Operator shall take *exclusive possession* of the operating rights of each Participant in and to the 64 Zone and enter into the performance of its duties hereunder; subject, however, to the right of each Participant to use and occupy its lands within the Area pursuant to Section 3 of Article II.” (Italics supplied.)

All that the Operator got, under this provision, was “exclusive possession” of the operating rights to the extent necessary for it to perform its duties as Operator; and it is material to note that, even in this instance, the possession of the rights by the Operator was as *agent* for the several Participants, in that Section 3 of Article XIII of the Unit Agreement provides as follows:

“It is the intention of each Participant to establish Operator as its agent under this agreement, for the sole purpose of developing, operating and protecting its interest in the 64 Zone to the extent herein set forth.”

Further in this regard, while the Operator is designated as the “agent” of each Participant, we have in this case

the circumstance that Belridge was both a Participant and the Operator. Under the law of agency a person cannot be the agent for himself, and certainly there is no contrary rule in tax law—a corporation cannot engage in tax-significant transactions with itself. It follows, therefore, that even if the taking of “exclusive possession of the operating rights” by the Operator, as agent, could be considered the transfer of a depletable interest (which respondent denies), there could not be a recognizable transfer of depletable interests between the respondent, as a Participant, and itself, as Operator-agent for itself. Incidentally, the circumstance that Belridge was designated and acted as Operator was not fortuitous nor was it subject to change without its consent. The respondent, as the largest producer in the Zone, and the holder of a 71.87% Participating Equity under the Agreement, was a natural and logical choice as Operator; and since the Agreement requires the vote of at least 80% of the Participating Equities to effect the removal of the Operator and the selection of a successor Operator (Art. III, Secs. 1 and 3(a)), the consent of the respondent would be required, since it controls 71.87% of the necessary votes.

The fact that the Participants had no intention of divesting themselves of their mineral interests in the 64 Zone, or otherwise, is further evidenced by the provision of Article XI of the Agreement [Ex. 3-C], which provides that each Participant shall retain the right at any time or from time to time, to sell, assign, transfer, quitclaim, surrender, or otherwise dispose of its interests, or any thereof, in or to the lands covered by the Agreement, including the 64 Zone. And the only limitation on this retained right of transfer or surrender is the limitation, common to any well drafted operating agreement, that no

transfer or surrender of an interest in lands, with respect to the 64 Zone, shall be made separate from a corresponding interest in Unit Wells and Unit Facilities, and no such transfer or surrender shall be made under such circumstances that the interests in the 64 Zone shall not remain subject to the Unit Agreement.

The retention by each Participant of all rights in the 64 Zone included the very "operating rights" which were entrusted to the "exclusive possession" of the Operator [Art. XI of Ex. 3-C], and each Participant reserved the right to sell, assign, transfer, quitclaim, surrender, or otherwise dispose of the operating rights, subject to the Agreement. This fact appears from not only the broad retention of rights stated in Article XI of the Agreement, but from the definition of "Participant" [Art. I, Sec. 1(e) of Ex. 3-C], which reads as follows (*italics supplied*):

"Participant shall mean an owner at the date of this agreement, *and each successor, assignee or transferee of such owner, of the right to develop and operate lands within the Area and to produce Unitized Substances*, whether as lessor or otherwise . . ."

The respondent submits that there is nothing in the form or substance of the Unit Agreement that remotely resembles a transfer of a mineral property interest in the 64 Zone, much less the reciprocal exchange of like mineral property interests, which the Court must find in order to sustain the Commissioner under the theory on which the deficiency was determined and the case was tried, argued, decided, and appealed. The word "exchange," as used in the internal revenue acts and codes, means:

". . . a mutual grant of equal interests, the one in consideration of the other. 'Exchange' is a word of precise import, meaning the giving of one thing for

another, requiring the transfers to be in kind.” (*Trenton Cotton Oil Co. v. Commissioner* (6 Cir., 1945), 147 F. 2d 33, at 36.)

Or, as expressed in the petitioner’s regulations (Reg. 111, Sec. 29.112(a)-1):

“To constitute an exchange within the meaning of section 112(b)(1) . . . the transaction must be a reciprocal transfer of property”

All that was intended, and effected, by the Unit Agreement was to entrust a single Operator (acting as the agent and in the interest of each individual Participant) with the task of developing, operating, and producing from the 64 Zone, to the end that the Zone might be operated economically as an engineering unit for conservation purposes, and thus avoid the unreasonable waste of oil, gas, and reservoir pressure that had occurred during the periods of unrestricted competitive production which preceded the effective date of the Unit Agreement.

The Tax Court could find “no intention on the part of the Participants to convey or exchange their economic interests in the 64 Zone” [R. 100], and the petitioner concedes, in the Petition for Review [R. 116] that “there was no expressed intention on the part of the participants to convey or exchange their economic interests in the Zone.” In the case of *Gowans v. Commissioner* (9 Cir., 1957), 246 F. 2d 448, at 451, your Honorable Court emphasized the importance of the intent, or purpose, factor as follows:

“It has been held that where the predominating purpose of the agreement is the economic exploitation of the deposits, this is indicative of a retained economic interest. . . . It would seem to follow that

where some other purpose predominates, the opposite conclusion concerning retention of economic interest would be invited.”

In the matter at issue, the Tax Court determined the *purpose* of the respondent, and the other unit Participants, to be as follows [R. 100-101]:

“The purpose which prompted the execution of the agreement in question was the recognition on the part of the Participants that unrestricted competitive production from the Zone was causing a lowering of the gas pressure and would eventually result in possible serious underground waste of oil, gas, and associated hydrocarbon products. For a period of some 5½ years prior to April 1, 1947, the participants had maintained a voluntary gas pressure program. . . . We think the unitization agreement here was nothing more than another joint effort on the part of the owners of the producing rights to the Zone to best conserve their respective individual interests therein by joining in a plan for the most economical and productive operation of the whole field. Hence, we think each Participant had exactly the same interests and rights in its respective properties after unitization as before, except that by mutual consent they had agreed to limit their production and operate their wells in the most economical feasible way from the standpoint of conservation requirements.”

For another, and excellent, statement of this same theme, see “Tax Problems in Unitization,” by John E. Kilgore, Jr., 1957 *Tulane Tax Institute* 1, at page 17:

“As stated above, the principal result of unitization is to modify the effect of the Rule of Capture and to realize, to some degree, the condition in which the owner of a surface tract embracing part of a reser-

voir can recover that part of the oil underlying his tract. To that extent, *the creation of a unit is the creation of a mechanism for realizing the value of property rights, and not a mechanism for exchanging old property rights for new ones.*" (Italics supplied.)

The applicable cases involving unit agreements, as well as considerations of national oil and gas conservation policy, completely support the Tax Court's determinations. *Phillips Petroleum Company v. Petersen* (10 Cir., 1954), 218 F. 2d 926, certiorari denied 349 U. S. 947, was not a tax case, but since the decision involves an excellent and exhaustive analysis of the substance of unitization agreements, including their necessity as a matter of national conservation policy, it has an obvious pertinence to the case at issue.

The *Phillips* case involved the validity of the unitization clause contained in some thirty-one oil and gas leases, which Phillips had obtained from Utah landowners. "Section 12" of each lease gave Phillips, as the lessee, the right to unitize, pool, or combine the subject property with other lands in the same general area by entering into a cooperative or unit plan of development or operation, in which event the lease shall be deemed modified to conform to the terms of the unit agreement; and the section also provided that unit production allocated to land under the unit agreement shall be regarded as having been produced from the land for the purpose of paying royalties under the lease. Under Section 12 the lessor agreed to give formal approval to the unit agreement by executing it at the request of the lessee.

Phillips had entered into a unit agreement for the Roosevelt Unit area in Utah, and included in the unitized area were state public lands and Indian lands, as well as

privately owned lands. Thirty-one of the lessors refused to sign the unit agreement, and Phillips brought action in the Federal District Court against them seeking declaratory judgments that Section 12 of the lease was valid and binding upon the lessors. The trial court found that Section 12 was invalid and unenforceable on the ground, among others, that no valid exercise of the power given by Section 12 could be made because of the rule against perpetuities. The appellate court stated the issue involved as follows (218 F. 2d at 930):

“Section 12 does not violate the rule against perpetuities, unless the unitization or pooling agreement accomplishes transfers of interests in real property, or, otherwise stated, effects cross-transfers of property interests among the parties to the agreement.”

The Court held that no cross-transfers of property interests were effected by unitization; hence the lease clause did not violate the rule against perpetuities.

In the course of its opinion in the *Phillips* case, *supra*, the Court quoted the following language from Section 12 of the leases:

“. . . In the event that said above-described lands or any part thereof, shall hereafter be operated under any such cooperative or unit plan of development or operation whereby the production therefrom is allocated to different portions of the land covered by said plan, then the production allocated to any particular tract of land shall, for the purpose of computing the royalties to be paid hereunder to lessor, be regarded as having been produced from the particular tract of land to which it is allocated and not to any other tract of land; and the royalty payments to be made hereunder to lessor shall be based upon production only as so allocated . . .” (218 F. 2d at 930.)

The Court interpreted this provision to mean in substance that “the effect of unitization was to be only with respect to allocation of production and the computation of royalties, and was not to effect cross-transfers of royalty interest” (218 F. 2d at 930). The Court (referring to the language of the unit agreement, as distinguished from the leases) further stated the following (218 F. 2d at 931):

“Moreover, an intent that there shall be no cross-transfers of royalty interests may be derived from a provision that proportions of the unit production shall be allocated to the respective tracts and that the portion so allocated to each tract shall be treated as if it had actually been produced from such tract. By such an allocation method of participation in unit production the parties clearly demonstrate their intention that the royalty and working interest ownership within each tract immediately prior to unitization shall continue in effect, since the static ownership within the respective tracts comprising the unit is the basis and the only basis upon which the allocation method of participation functions.”

[The Unit Agreement at issue in this appeal [Ex. 3-C] likewise provides for the allocation of unit production on the basis of the static ownership within the respective tracts involved in the Unit; see Art I, Sec. 1(e) to (h); Art. II, Sec. 1; Art. IV, Sec. 7; Art V, Sec. 1; Art. VII, Secs. 1, 3, and 4; Art X, Sec. 1; Art. XI; Art. XIII, Secs. 3 and 4; and Ex. E, which is part of Trial Ex. 3-C.]

The Court in the *Phillips* case, *supra*, stated that the unit agreement it was considering “clearly provided” that cross-transfers of property interest were *not* to be effected by

unitization, by virtue of the following provisions [which find their counterparts in the portions of Ex. 3-C, cited in the preceding paragraph]:

“ . . . Nothing herein, however, shall be construed to transfer title to any land or to any lease or operating agreement, it being understood that under this agreement the Unit Operator, in its capacity as Unit Operator, shall exercise the rights of possession and use vested in the parties hereto only for the purposes herein specified.

“ . . . All unitized substances produced from each participating area established under this agreement . . . shall, . . . be deemed to be produced equally on an acreage basis from the several tracts of unitized land of the participating area . . . and, for the purpose of determining any benefits accruing under this agreement, . . . each tract of unitized land shall have allocated to it such percentage of said production as the number of acres in such tract bears to the total acres of unitized land in said participating area” (218 F. 2d at 930-931.)

The decision in the *Phillips* case, *supra*, devotes several pages to demonstrating the desirability of oil and gas unitization agreements as an instrument of the long-established national policy to conserve and prevent undue waste of vital natural resources (218 F. 2d pp. 931-933). Among other things, the Court stated the following:

“Provisions in oil and gas leases for unitization have become a practical necessity in the oil and gas industry, because of governmental rules and regulations imposing strict requirements for the proper spacing of wells and the granting of production allowables on the basis of formulae predicated in whole or in part on the quantity of acreage from which the

oil and gas can be efficiently recovered by one well completed in the reservoir involved. Permeability, porosity, and other information relating to the producing zone can be scientifically analyzed and a reasonably accurate determination made of the area from which the oil can be efficiently recovered by a well in that zone for the purpose of fixing the appropriate size of the pooled units for developing such zone. See Hoffman, Voluntary Pooling and Unitization, pp. 87, 88. Moreover, limiting the number of wells to be drilled to those that will efficiently recover the oil and the elimination of the drilling of unnecessary wells will prevent underground waste and the loss of oil which would result if unnecessary wells were drilled.” (218 F. 2d 931-932.)

The Court traces some of the history of various Congressional acts authorizing and promoting unitization of federally controlled mineral lands (beginning with the *Act of July 3, 1930, 46 Stat. 1007; 30 U. S. C. A., Sec. 184 and Section 226*), and referred to the efforts of the Department of the Interior to promote and standardize unitization; and the Court stated the following (218 F. 2d at 933):

“Thus, it will be seen that unitization is a conservation measure which benefits both lessor and lessee and tends to prevent waste of a natural resource.

“The practice of unitization by a power granted the lessee in advance, if faithfully carried out, will be fair and profitable both to the lessor and lessee, and is vital to the oil and gas industry in the interests of the conservation of both natural and material resources. It should be upheld”

It is submitted that the interpretation of the unit agreement by the Court in the *Phillips* case, *supra*, constitutes a controlling precedent in the interpretation of similar language contained in the Unit Agreement at issue. It is further respectfully submitted that the concern, evidenced by the Court in the *Phillips* case, to avoid a decision that might impede the usefulness of unitization as a measure to conserve vital natural resources, should find like expression in the deliberations of your Honorable Court. That is, the continued use of unitization as a tool for the conservation of natural resources should not be impeded by the danger that a "booby trap" in the nature of perilous changes in depletion allowances may be attached. Tax uncertainty might well bring an end to a constructive program of conservation that is part of our policy as a nation. Some appreciation of the intense Federal interest in oil and gas unitization as an instrument of Federal conservation policy can be obtained from the 1955 address of J. Revel Armstrong, Solicitor of the Department of the Interior, published in *First Annual Rocky Mountain Mineral Law Institute* (Mathew Bender & Company, 1955) pages 45-57. Further, it was a requirement of California law (*Public Resources Code of the State of California*, Sec. 3301) that, before the Unit Agreement at issue could become effective, there had to be a determination by the State Oil and Gas Supervisor that it is in the interest of the protection of oil and gas from unreasonable waste that the Agreement be entered into. This determination was made by the Supervisor and he expressly approved the Agreement [Ex. 3-C, p. 45]. Thus, the Agreement at issue is entitled to solicitous consideration by the Court as an instrument of State, as well as national, conservation policies.

The case of *Campbell, Jr. v. Fields* (5 Cir., 1956), 229 F. 2d 197 (affirming D. C. Texas; unofficial report 55-1 U. S. T. C. par. 9318) was an income tax case involving the question whether expenditures for surveying charges and attorneys' fees paid in connection with the unitization of gas leases, to comply with the Texas law relating to pooling and unitization, were deductible as business expenses "incurred in order that taxpayers might realize and enjoy income" (229 F. 2d 197, at 203), or were they capital expenditures incurred in the "modification of the leases resulting in their conversion into unitized proration units calculated to increase their capital value" (229 F. 2d 197, at 201).

The facts in *Campbell, Jr. v. Fields* were that the Texas Railroad Commission issued an order restricting the drilling of gas wells, in the Waskon Field, to one well for each 640-acre unit. Taxpayers (husband and wife) incurred the expenses in forming five proration units—in three of them they owned all of the leases, but in the other two units, the taxpayers combined their leases with leases owned by G. Corporation and S. Corporation, in order to make up two proration units of approximately 640 acres each. A "Pooling and Operating Agreement" was executed by the taxpayers and G. Corporation, with respect to one unit, and a similar agreement was executed by the taxpayers and S. Corporation, with respect to the other unit. Agreements between the owners of royalty interests and the lessees, approving proration and unitization, were prepared and executed. The taxpayers claimed the expenses as deductions in their joint return for 1948, and upon disallowance, paid the deficiency and sued for refund, which the District Court and the Appellate Court granted.

The Court said that the Government's approach to the problem "gives too much consideration to form and too little to substance" (229 F. 2d at 201) and that it was necessary to "examine the nature of the property right as was evidenced by the leases and the extent to which that right was changed by the pooling and unitization" (229 F. 2d at 201). The Court then stated its analysis of the basic nature of the transaction as follows (229 F. 2d at 201-202):

"Prior to the formation of a proration unit each participant had the right to a share in the gas in the field to be produced through wells on the land owned by or leased to him even though some part of it may have migrated from the lands of others. These rights were correlative, each owner or lessee of land embracing the field having the right to the oil and gas therein subject to like rights of the others. The enjoyment of these rights was limited by the requirement of well spacing imposed by the State of Texas in the exercise of its police power. The well spacing requirement made pooling and unitization necessary in order to preserve and protect the rights of the taxpayers to their proportionate share of the gas in the field. The pooling and unitization here involved covered only the gas rights. Subsequent to the pooling and unitization each owner and lessee has the right to a share in the gas in the field to be produced through wells on the land included in the unit, each participant's portion being measured by the area of his contribution to the unit. *His ultimate economic interest is little, if any, different after pooling and unitization than before.*

"It cannot be said as a matter of law, and we doubt that there could be any accurate determination as a matter of fact, whether the ultimate realization

by taxpayers would be greater or less with unitization than without well spacing and unitization. *We do not find that the unitization of the leases resulted in any such conversion of the character of taxpayers' investment as worked a basic change in the nature of the property right which they held.*" (Italics supplied.)

The Court further stated (229 F. 2d at 203) that:

"Here the controverted deductions were not made for acquiring property or defending title to property, nor for the purpose of converting one kind of property into some different kind of property. Here the expenses were incurred in order that the taxpayers might realize and enjoy the income from the property."

The decision in *Campbell v. Fields*, *supra*, necessarily involved the determination that, in substance, no exchange of mineral interests is involved in the unitization of the operating rights incident to oil and gas lease working interests, and, as such, the decision is a precise precedent for upholding the Tax Court's determination in this case.

In his brief, the petitioner erroneously regards common ownership of depreciable equipment [Art. VII, Sec. 2 of Ex. 3-C] as being indicative of a common economic interest in a new producing "property." This approach is but a rehash of an "elaborate argument" previously rejected by the United States Supreme Court. In the case of *Choate v. Commissioner* (1945), 324 U. S. 1, 65 S. Ct. 469, 89 L. Ed. 653, the facts were that the Choate and Hogan partnership owned an oil and gas lease on which were six producing wells and a variety of *depreciable* property (well equipment, casing, piping, pumps, tanks, etc.). The partnership "sold" all its right,

title and interest in the lease and the depreciable property to S. Co. for cash; but expressly *reserved and retained* an overriding royalty of one-eighth of all oil, gas and casinghead gas produced and saved. The taxpayer reported the transaction as a sale. The Tax Court held that while there was an absolute sale of the *depreciable* equipment, the reservation or retention of an interest in production meant that no sale of the lease had taken place. The Tax Court stated the following (*italics supplied*):

“Where a royalty interest is *retained*, as was the case here, the principle of recovery by depletion rather than by treatment as a sale applies to all receipts, including any cash bonus which is regarded as in the nature of advance royalties.” (*Hogan, et al.* (1942), 1 T. C. M. 208 at 211.)

The Commissioner objected to the Tax Court ruling that a sale of the depreciable equipment had taken place; and before the Supreme Court the Commissioner made what the Court termed an “elaborate argument,” on the assumption that “after the partnership transferred its interest in the lease its investment was no longer in the leasehold and equipment as such but was an economic interest in an oil-producing enterprise—an interest which is depletable since it is measured by the production of oil.” The Supreme Court was not impressed by this argument, and upheld the Tax Court’s determination that while the partnership had sold the equipment, it had retained its economic interest in the lease since it retained a right to share in production from the leasehold.

In the Tax Court case of *Whitwell* (1957), 28 T. C. 372 (now on appeal by taxpayer to the Fifth Circuit), compulsory unitization under the Louisiana statute was involved, and the unitization order directed that the tax-

payer be compensated for the actual costs, expended by him, prior to unitization, to develop the unitized wells, which amounted to \$48,000, in round figures. The unitization order directed that this payment be made out of 80% of the unit production from the "particular participating area" in which the unitized wells were situated. Taxpayer reported no part of the sum as taxable income, but the Commissioner determined a tax deficiency on the basis that the sum was depletable income "from the operation of income producing property in which you owned and/or retained an economic interest." On appeal to the Tax Court, taxpayer argued that he had "exchanged" his wells for an interest in the unit, and in the process had received the \$48,000 as "boot" money on the exchange, giving rise to capital gain on a taxable exchange. The Commissioner argued before the Tax Court that a "tax-free exchange" had taken place, and that the \$48,000 was not received as "boot" money, but as ordinary depletable income.

The Tax Court said:

"We do not think it was necessary for the (Commissioner) to argue that there was a nontaxable exchange of interests here in order to sustain his determination that the oil payments constituted ordinary income to the petitioners subject to depletion";

and the Court held that since there was no doubt the taxpayer had an economic interest, the payment to them out of the proceeds of oil production was depletable income, just as the Commissioner's deficiency notice had determined.

In the course of its opinion in the *Whitwell* case, *supra*, the Tax Court cited with approval its own opinion in the *Belridge* case; and stated that said opinion was a

complete answer to the “exchange” theory advanced by both parties in the *Whitwell* case. The Tax Court said:

“ . . . unitization amounts to no more than a production and marketing arrangement as between owners of oil producing property or rights.

“ . . . No interests were assigned or exchanged. There was merely an allocation of the production of oil from the pool beneath their several properties based on both acreage and development costs.”

For some undisclosed reason, the petitioner contends on brief that the *Whitwell* case, *supra*, amounts to a recognition by the Tax Court “that a new depletable interest can be created by virtue of a unitization agreement” (Pet. Op. Br. 20-21). Petitioner does not elaborate on this bald statement, which seems manifestly unsound. The opinion in the *Whitwell* case discloses that the sum in dispute was payable from a specified portion (80%) of the production “from the particular participating area” in which the taxpayer’s unitized wells were located; that the Commissioner’s deficiency determination was on the basis that taxpayer “owned and/or retained” an economic interest in the property from which the production payment was made, and that said payment constituted depletable income; and the Tax Court upheld this determination. In other words, the essence of the *Whitwell* opinion and decision was that the taxpayer retained his original mineral interests despite unitization, and that the production payment was depletable income derived from the properties in which he *retained* his interests. Neither the deficiency determination nor the Tax Court’s holding made any mention of a new depletable interest, despite the petitioner’s unsupported statement to the contrary.

The respondent's misconception of the *Whitwell* case, *supra*, highlights the fundamental error of theory and analysis which permeates his brief. For example, on pages 17-18 of his brief, the respondent makes the following erroneous statement (*italics supplied*):

“ . . . the execution of an oil and gas lease by a landowner for a lump sum consideration and future payments from production amounting to a royalty interest, as in *Burnet v. Harmel*, 287 U. S. 103, *creates a new depletable interest (the royalty interest)* even though, as the Supreme Court expressly held in the *Harmel* case, the transaction is not a sale or exchange of property.”

Burnet v. Harmel does not stand for the proposition for which it is cited, and the Commissioner is completely in error in contending that a landowner “creates a new depletable interest” for himself by virtue of a leasing transaction. *The correct view is that the landowner retains or reserves the economic interest he already had if he reserves any continued interest in production*, and that is why the leasing transaction is not regarded as a sale, exchange, or other disposition of the landowner's economic interest. (*Burnet v. Harmel* (1932), 287 U. S. 103, 53 S. Ct. 74, 77 L. Ed. 199; *Palmer v. Bender* (1933), 287 U. S. 551, 53 S. Ct. 225, 77 L. Ed. 489; *Thomas v. Perkins* (1937), 301 U. S. 655, 57 S. Ct. 911, 81 L. Ed. 1324; *Burton-Sutton Oil Company v. Commissioner* (1946), 328 U. S. 25, 68 S. Ct. 861, 90 L. Ed. 1062; *Commissioner v. Southwest Exploration Company* (1956), 350 U. S. 308, 76 S. Ct. 395, 100 L. Ed. 347; *Gowans v. Commissioner* (9 Cir., 1957), 246 F. 2d 448; *G. C. M. 22730*, 1941-1 C. B. 214; *G. C. M. 27322*, 1952-2 C. B. 62.) *G. C. M. 22730, supra*,

states the correct and applicable principle as follows (1941-1 C. B. at p. 216):

“ . . . the lessor, by lease terms reserving royalties, merely grants to the lessee exclusive exploitation privileges, retaining as his share of the oil and gas in place that portion thereof which, freed of the burdens of development and operating costs, has a value equivalent to the value of the entire interest subject to such burdens, and, therefore, like the lessor of an ordinary lease reserving rent, is regarded as not having disposed of a capital asset. The remaining fractional interest in oil and gas in place becomes the share of the lessee's working or operating interest which carries the risks and burdens attending exploitation . . . So considered, the view that a lessor, or a sublessor or assignor, parts with no capital interest, though the lessee, sublessee, or assignee acquires a capital interest upon the execution or assignment of a lease, presents no logical difficulties as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery. Under this theory, the lessee does not pay rent to the lessor by royalty payments but, instead, divides the product or the proceeds realized therefrom with him . . . The lessor does not sell an interest to the lessee. Instead, the lessee acquires an interest by assuming the obligation to develop and operate the property.”

See also the statements of your Honorable Court in the *Gowans* case, *supra* (italics supplied):

“In a series of decisions beginning with *Palmer v. Bender*, 287 U. S. 551, 53 S. Ct. 225, 77 L. Ed. 489, the principle has been developed that an arrangement involving the extraction and removal of nat-

ural deposits from the land of another, is to be deemed a 'sale' only if, at the time such arrangement is entered into, *the owner has alienated all interest therein*. Stated conversely, if an economic interest in the deposits *has been retained*, the transaction is not regarded as a 'sale' for tax purposes." (246 F. 2d at 450.)

"An economic interest *has been retained* where the owner has: (1) acquired, by investment, any interest in the natural deposit in place; and (2) secured by any legal relationship income derived from the extraction of the natural deposit to which he must look for a return of his capital." (246 F. 2d at 451.)

The respondent knows of no case which supports the petitioner's claim that a leasing, etc., transaction "creates" a new depletable interest in an owner who already had the entire depletable interest, and the cases cited in the petitioner's brief are directly to the contrary. And since the petitioner is so completely in error in his analysis of the leasing transaction, it is understandable that he would misconstrue the substance and effects of a unit agreement, such as the one at issue here. A fee owner of depletable oil and gas property (such as the respondent in this case) by virtue of his fee ownership possesses (among other things) the equivalent of the following elements:

1. The entire landowner, or royalty, interest.
2. The entire working interest, consisting of:
 - (a) the exclusive right to enter and explore for oil and gas;
 - (b) the exclusive right to develop, operate and produce oil and gas;

(c) the right to retain or dispose of all production, exclusive of the interest in production encompassed by item 1 above;

(d) the obligation to bear the expenses of the exploitation, development, operation, production, etc., activities.

Under the principles announced by the cases and rulings, the land owner can lease or transfer the *entire working interest* (items 2(a) to 2(d) above), and still is not regarded, for tax purposes, as having made a sale, exchange, or other disposition of his or its depletable economic interest, *as long as the landowner retains a right to share in production* (that is, *retains* all or part of the interest designated as item 1, above). In the present case, the respondent, by virtue of the Unit Agreement [Ex. 3-C], simply “transferred” to itself, as Operator, the “exclusive possession” of “operating rights” (the equivalent of items 2(a) and 2(b) above), *retaining* to itself the right to *all* production applicable to its interest (that is, it retained to itself the equivalent of the sum of the production applicable to both the landowner’s interest and the working interest). It is obvious from this analysis that, under the principles announced by the cited Supreme Court cases and your decision in *Gorvans v. Commissioner, supra*, the Unit Agreement did not and could not, in substance result in any change in the nature or the amount of the respondent’s depletable economic interests in the 64 Zone mineral property underlying its Main and Result properties. And the Tax Court was right in holding that under the Unit Agreement in this case, “each Participant had exactly the same interests and rights in its respective properties after unitization as be-

fore, except that by mutual consent they had agreed to limit their production and operate their wells in the most economically feasible way from the standpoint of conservation considerations" [R. 101].

IV.

The Petitioner Errs in His Conception of the Rationale of the Depletion Deduction and the Mechanics of Computing It.

On pages 19 and 20 of his brief, petitioner is critical of the method prescribed by the Tax Court for computing cost depletion on the Result Property. The petitioner terms it "unrealistic," and contends that if the petitioner's theory of separate economic interest is adopted then, according to petitioner, "the very nature and separateness of taxpayer's unitized interest affords a simple and much more realistic basis for computing taxpayer's depletion deduction with respect to 64 Zone oil."

The absurdity of the petitioner's pretention is made evident from these facts:

(a) Petitioner is criticizing the Tax Court because it used, in the depletion computation, the number of barrels of unit production allotted to the Result Property (11,859 barrels), although actual production from wells located on the surface area of the Result Property totalled 21,672 barrels.

(b) Yet, if we accept the petitioner's view that the respondent's unitized 64 Zone interests are a separate property, we have the situation that the number of barrels of unit production allotted to the alleged separate property totalled 307,704 barrels, although actual production from wells on the surface area of the alleged separate property totalled 237,062 barrels [R. 46, Stip. pars. 22, 23].

How is the computation of depletion made “simple and much more realistic” under the petitioner’s separate property theory, in the light of the above stipulated facts? (The preceding rhetorical question is posed without consideration of the additional important fact that the record is devoid of evidence concerning the cost basis and the oil reserves of the alleged separate property, so that a depletion computation could not be made in any event under the petitioner’s theory.)

The respondent submits that the solution to the problem is in fact simple, and that the Tax Court found and adopted the simple and realistic solution. The key to the answer is this: Under the statute and the regulations, percentage depletion and cost depletion computations have to be correlated and compared in order to determine which gives the greater depletion allowance. It logically follows that the computations have to be made on a comparable basis, and *that basis is the number of units (barrels, etc.) sold*, not the number of units produced. This is obvious in the case of the percentage depletion computation—since percentage depletion is based on gross receipts, you consider only the number of barrels sold, for only those are productive of gross receipts. The point may be less obvious in the case of the cost depletion computation, since many persons (and some court opinions) loosely speak of cost depletion in terms of “production”; yet the applicable regulations (Reg. 111, Sec. 29.23(m)-2, App. A, *infra*) plainly states that in computing cost depletion the depletion unit (obtained by dividing the reserve into the dollar amount of the adjusted cost basis) shall be multiplied by:

“the number of units of mineral *sold* within the taxable year.” (Italics supplied.)

The plain fact that cost depletion is *not* geared to production, but that it *is* geared to gross receipts, is made evident by the definition, in the cited regulation, of “units sold” in the case of a cash basis taxpayer. The definition is as follows (Reg. 111, Sec. 29.23(m)-2, App. A, *infra*):

“As used in this section the phrase ‘number of units sold within the taxable year,’ in the case of a taxpayer reporting income on the cash receipts and disbursements basis, includes units for which payments were received within the taxable year although produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year.”

Once we accustom our thinking to the fact that both the percentage depletion computation and the cost depletion computation must be in terms of units sold, not units produced, then the solution of the unitized production problem is simple, for in each case you look to the number of units *allotted* to the participant, for that is the number of units he can and does sell. He can’t sell what he doesn’t get and is not entitled to, even though it may have been produced from wells located on the surface area of his property subject to the unit agreement.

In this case, the Tax Court correctly computed percentage and cost depletion in terms of the number of units sold, not the number of units produced [R. 103-104, 104-111]. And since the estimated number of units in the underground reserve is subject to periodical *prospective* revision, at the instance of either the Commissioner or the taxpayer, there is no ground for concern that the reserve will become unbalanced or exhausted prior to the recovery of cost (Reg. 111, Sec. 29.23(m)-9, App. A, *infra*; and see *Ah Pah Redwood Company v. Commissioner* (9 Cir., 1957), 251 F. 2d 163.)

Conclusion.

The decision of the Tax Court of the United States is in accordance with the law and its findings are not clearly erroneous; therefore, the decision should be affirmed.

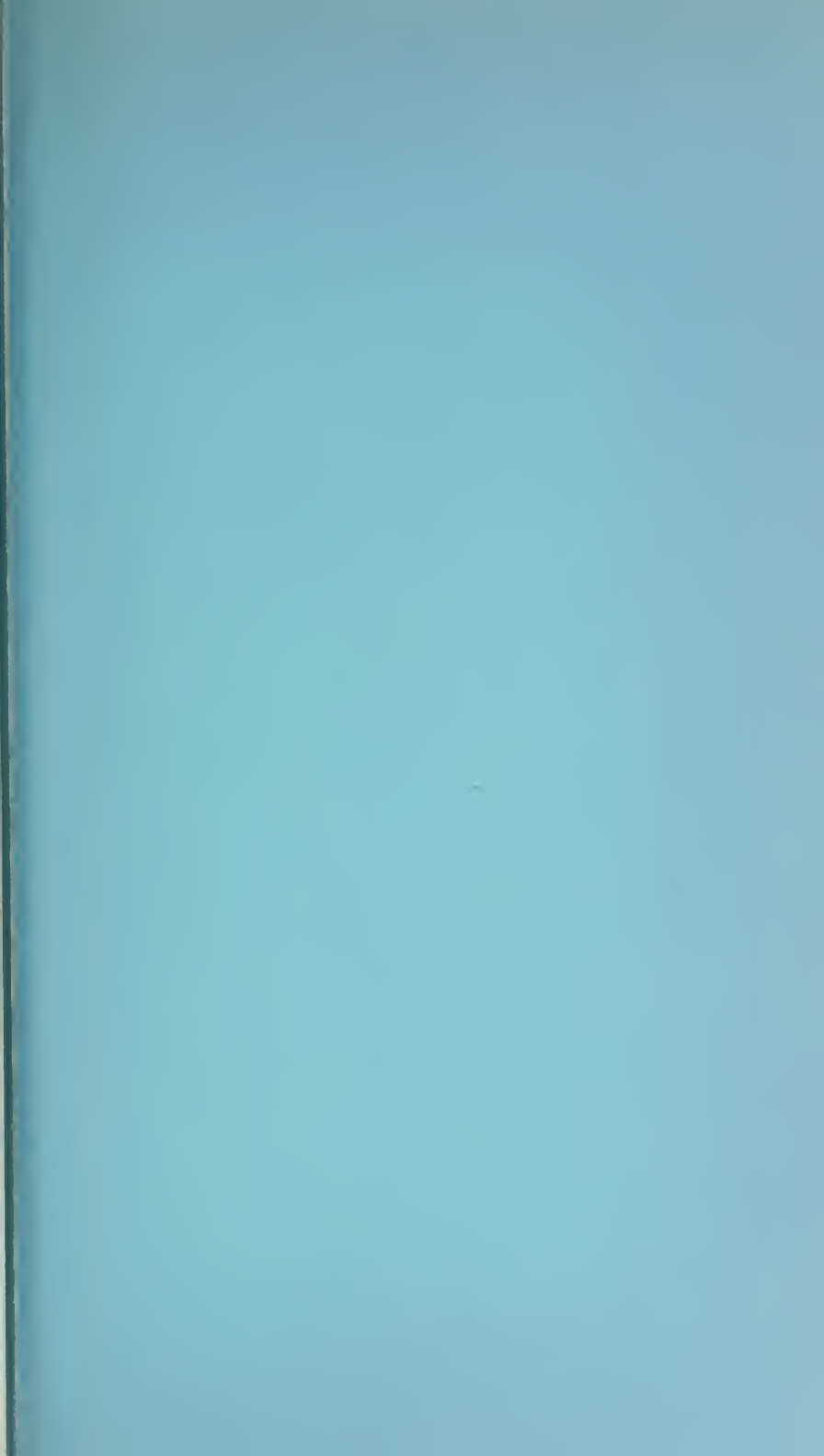
Respectfully submitted,

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Counsel for Respondent.

June 20, 1958.



APPENDIX A.

Statutes and Regulations Involved.

Statutes.

Internal Revenue Code of 1939, Section 23 (m). (26 U. S. C. A. (I. R. C. 1939) Sec. 23 (m))

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

* * * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the

pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).

Internal Revenue Code of 1939, Section 114 (b) (1) and (3). (26 U. S. C. A. (I. R. C. 1939) Secs. 114 (b) (1) and (3))

Sec. 114. BASIS FOR DEPRECIATION AND DEPLETION

* * * * *

(b) Basis for Depletion.—

(1) General Rule.—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * *

(3) Percentage Depletion For Oil and Gas Wells.—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be $27\frac{1}{2}$ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

Internal Revenue Code of 1939, Section 113 (a) (6) (26 U. S. C. A. (I. R. C. 1939) Sec. 113 (a) (6))

Sec. 113. Adjusted Basis For Determining Gain or Loss.

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

* * * * *

(6) Tax-Free Exchanges Generally.—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, or section 112 (1), the basis * * * shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112 (b) or section 112 (1) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. Where as part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for the purposes of this paragraph, be considered as money re-

ceived by the taxpayer upon the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

Internal Revenue Code of 1939, Section 113 (b) (1) (B) & (C) (26 U. S. C. A. (I. R. C. 1939) Sec. 113 (b) (1) (B) & (C))

Sec. 113. Adjusted Basis For Determining Gain or Loss.

* * * * *

(b) Adjusted Basis.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) General Rule.—Proper adjustment in respect of the property shall in all cases be made.

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(i) allowed as deductions in computing net income under this chapter or prior income tax laws, and

(ii) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this chapter (other than subchapter E), subchapter E of chapter 2, or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this chapter of prior income tax laws. Clause (ii) of this subparagraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under subsection (d). Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(C) in respect of any period prior to March 1, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

Internal Revenue Code of 1939, Section 112 (b) (1) (26 U. S. C. A. (I. R. C. 1939) Sec. 112 (b) (1))

Sec. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) Exchanges Solely In Kind.—

(1) Property Held For Productive Use Or Investment.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

United States Treasury Department Regulations.

(Promulgated under the Internal Revenue Code of 1939)
Reg. 111, Section 29.23 (m)-1 (26 C. F. R., 1949 Edition,
Sec. 29.23(m-1). Depletion of Mines, Oil and Gas Wells,
Other Natural Deposits and Timber; Depreciation of
Improvements.—

Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. However, no depletion deduction shall be allowed with respect to any timber which the owner has disposed of under any form of contract by virtue of which the owner retains an economic interest in such timber; if such disposal is considered a sale of the timber under section 117(k)(2) of the Code. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between

the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * * *

When used in these sections (29.23(m)-1 to 29.23(m)-28, inclusive) covering depletion and depreciation—

(a) The “fair market value” of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

(b) A “mineral property” is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction. The value of a mineral property is the combined value of its component parts.

(c) The term “mineral deposit” refers to minerals in place. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

* * * * *

(f) The term “gross income from the property”, as used in sections 114(b)(3) and 114(b)(4)(A) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the following:

In the case of oil and gas wells, “gross income from the property” as used in section 114(b)(3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If

the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation.

* * * * *

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property."

* * * * *

(g) "Net income of the taxpayer (computed without allowance for depletion) from the property," as used in section 114(b)(2), (3), and (4) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the "gross income from the property" as defined in paragraph (f) of this section less the allowable deductions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (f) in so far as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. Deductions not directly attributable to particular properties or processes shall be fairly allocated. * * * If more than one mineral property is involved, the deductions apportioned to the mineral extraction and the processes listed in

paragraph (f) shall, in turn, be fairly apportioned to the several properties, taking into account their relative production.

(h) "Crude mineral product," as used in paragraph (f) of this section, means the product in form in which it emerges from the mine or well.

(i) "The property," as used in section 114(b)(2), (3), and (4) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the interest owned by the taxpayer in any mineral property. The taxpayer's interest in each separate mineral property is a separate "property"; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single "property," provided such treatment is consistently followed.

Reg. 111, Section 29.23(m)-2 (26 C. F. R., 1949 Edition, Sec. 29.23(m)-2). Computation of Depletion of Mines, Oil and Gas Wells, and Other Natural Deposits, Without Reference to Discovery Value or Percentage Depletion.—

The basis upon which depletion, other than discovery depletion or percentage depletion, is to be allowed in respect of any property is the basis provided in section 113(a), adjusted as provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property. (See sections 29.113(a)-1 to 29.114-1, inclusive.) If the amount of the basis as adjusted applicable to the mineral deposit has been determined for the taxable year, the depletion for that year shall be computed by dividing that amount by the number of units of mineral remaining as of the taxable year, and by

multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year. In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

As used in this section the phrase “number of units sold within the taxable year,” in the case of a taxpayer reporting income on the cash receipts and disbursements basis, includes units for which payments were received within the taxable year although produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year. The phrase does not include units with respect to which depletion deductions were allowed or allowable prior to the taxable year.

“The number of units of mineral remaining as of the taxable year” is the number of units of mineral remaining at the end of the year to be recovered from the property (including units recovered but not sold) plus the “number of units sold within the taxable year” as defined in this section.

In determining the amount of the basis as adjusted applicable to the mineral deposit there shall be excluded (a) amounts representing the cost or value of the land for purposes other than mineral production (b) the amount recoverable through depreciation and through deductions other than depletion, and (c) the residual value of other property at the end of operations, but there shall be included, in the case of oil and gas wells, those amounts of capitalized drilling and development costs which, as provided in section 29.23(m)-16, are recoverable through depletion.

In the case of a natural gas well where the annual production is not metered and is not capable of being estimated with reasonable accuracy, the taxpayer may compute the depletion allowance (without reference to percentage depletion) in respect of such property for the taxable year by multiplying the adjusted basis of the property by a fraction, the numerator of which is equal to the decline in closed or rock pressure during the taxable year and the denominator of which is equal to the expected total decline in closed or rock pressure from the taxable year to the economic limit of production. Taxpayers computing depletion by this method must keep accurate records of periodic pressure determinations.

Reg. 111, Section 29.23(m)-4. (26 C. F. R., 1949 Edition, Sec. 29.23(m)-4) Computation of Depletion Based on a Percentage of Income in Case of Oil and Gas Wells.—

Under section 114(b)(3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to $27\frac{1}{2}$ percent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see section 29.23(m)-1 (f) and (g).) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113.

Reg. 111, Section 29.23(m)-7 (26 C. F. R., 1949 Edition, Sec. 29.23(m)-7) Determination of Fair Market Value of Mineral Properties, Including Oil and Gas Properties.—

(a) If the fair market value of the property at a specified date is to be determined for the purpose of ascertaining the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purposes of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, and, in the absence of better evidence, disinterested appraisals by approved methods. Valuations by analytic appraisal methods, such as the present value method, are not entitled to great weight, (1) if the value of a mineral deposit can be determined upon the basis of cost or replacement value, (2) if the knowledge of the pres-

ence of the mineral has not greatly enhanced the value of the mineral property, (3) if the removal of the mineral does not materially reduce the value of the property from which it is taken, or (4) if the profits arising from the exploitation of the mineral deposit are wholly or in great part due to the manufacturing or marketing ability of the taxpayer or to extrinsic causes other than the possession of the mineral itself. If the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method.

* * * * *

(d) Mineral deposits of different grades, locations, and probable dates of extraction in a mineral property should be valued separately.

* * * * *

(e) The value of each mineral deposit is measured by the expected gross income (the number of units of mineral recoverable in marketable form multiplied by the estimated market price per unit) less the estimated operating cost, reduced to a present value as of the date as of which the valuation is made at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at that date of the depreciable assets and of the capital additions, if any, necessary to realize the profits.

* * * * *

(f) If, for the purpose of the equitable apportionment of depletion among the several owners of economic interests, the value of any mineral property must be ascertained as of any specific date for the

determination of the basis for depletion, the values of the several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral property in fee simple.

Reg. 111, Section 29.23(m)-8 (26 C. F. R., 1949 Edition, Sec. 29.23(m)-8). Revaluation of Mineral Deposits Not Allowed.—

No revaluation of a property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved.

* * * * *

The value should be redistributed—

(a) If a revision of the number of remaining recoverable units of mineral in the property has been made in accordance with section 23(m) and section 29.23(m)-9, and

(b) In the case of the sale of a part of the property, between the part sold and the part retained.

Reg. 111, Sec. 29.23(m)-9. (26 C. F. R., 1949 Edition, Sec. 29.23(m)-9. Determination of Mineral Contents of Mines and of Oil and Gas Wells.—

If it is necessary to estimate or determine with respect to any property as of any specific date the total recoverable units (tons, pounds, ounces, barrels, thousands of cubic feet, or other measure) of mineral products reasonably known, or on good evidence believed, to have existed in the ground as of that date, the estimate or determination must be made

according to the method current in the industry and in the light of the most accurate and reliable information obtainable. In the selection of a unit of estimate, preference shall be given to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the property for the purposes of valuation and depletion shall include as to both quantity and grade—

(a) The ores and minerals “in sight,” “blocked out,” “developed,” or “assured,” in the usual or conventional meaning of these terms with respect to the type of the deposit, and

(b) “Probable” or “prospective” ores and minerals (in the corresponding sense), that is, ores and minerals that are believed to exist on the basis of good evidence although not actually known to occur on the basis of existing development; but “probable” or “prospective” ores and minerals may be estimated (1) as to quantity, only in case they are extensions of known deposits or are new bodies or masses whose existence is indicated by geological or other evidence to a high degree of probability, and (2) as to grade, only as accords with the best indications available as to richness.

If the number of recoverable units of mineral in the property has been previously estimated for the prior year or years, and if there has been no known change in the facts upon which the prior estimate was based, the number of recoverable units of mineral in the property as of the taxable year will be the number remaining from the prior estimate, but in any case in which it is ascertained either by one taxpayer

or the Commissioner as the result of operations or development work prior to the close of the taxable year that the remaining recoverable mineral units as of the taxable year are materially greater or less than the number remaining from the prior estimate, then the estimate of the remaining recoverable units shall be revised and the annual depletion allowance with respect to the property for the taxable year and for subsequent taxable years will be based upon the revised estimate unless a change in the facts requires another revision. Such revised estimate will not, however, affect the basis for depletion.

Reg. 111, Section 29.112(b)(1)-1 (26 C. F. R., 1949 Edition, Sec. 29.112(b)(1)-1). Property Held for Productive Use in Trade or Business or for Investment.—

As used in section 112(b)(1), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unim-

proved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

A transfer is not within the provisions of section 112(b)(1) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer, but such transfer, if otherwise qualified, will be within the provisions of section 112(c).

Gain or loss is recognized if a taxpayer exchanges (1) Treasury bonds maturing October 15, 1945, for Treasury bonds maturing June 15, 1963, or (2) a real estate mortgage for bonds of the Home Owners' Loan Corporation.

Reg. 111, Section 29.113(b)(1)-1. (26 C. F. R., 1949 Edition, Sec. 29.113(b)(1)-1.) Adjusted Basis: General Rule.—

The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost of such property or, in the case of such property as is described in section 113(a)(1) to (22), inclusive, the basis therein provided, adjusted to the extent provided in section 113(b).

The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. In the case of mines and oil or gas wells the following shall not be considered as items properly chargeable to capital account: (1) Expenditures made
* * * which are allowable under * * * regulations as deductions in computing net income;

* * * * *

The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent such deductions have in respect to any

period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under chapter 1 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto, whichever is the greater amount. A taxpayer is not permitted to take advantage in later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period.

* * * * *

The deductions by which the cost or other basis is to be decreased shall include deductions allowed under section 114(b) (2), (3), and (4) of the Revenue Act of 1932, the Revenue Act of 1934, the Revenue Act of 1936, the Revenue Act of 1938, and the Internal Revenue Code, for the taxable year 1932 and subsequent taxable years, but the amount of the diminution in respect of depletion for taxable years prior to 1932 shall not exceed a depletion deduction computed without reference to discovery value in the case of mines, or without reference to discovery value or a percentage of income in the case of oil and gas wells.

The cost or other basis shall also be decreased by the exhaustion, wear and tear, obsolescence, amortization, and depletion sustained in respect of any period prior to March 1, 1913.

* * * * *

APPENDIX B.

Demonstration From the Record That the Petitioner Has Abandoned the Theory of the Case, and Is Advancing an Entirely New Theory on Appeal.

An examination of the record in this proceeding clearly demonstrates that the Tax Court and the parties all considered the basic issue to be in terms of the “exchange” theory, which the petitioner has abandoned in this Court; and that the petitioner’s new “merger” theory was not pressed before the Tax Court, nor ruled upon by that body. In the first place, the parties stipulated to the admission of *Joint Exhibit 2-B* (the report of the examining officer) “for the purpose of showing the basis used by the respondent (the petitioner in this Court) in determining the deficiency here at issue.” [Stip. of Facts, par. 4, R. 38-39, 67, portion in parenthesis supplied in the foregoing quotation.] Item (a) of Schedule 1(a) of *Joint Exhibit 2-B* states the basis of the depletion adjustment to be “that a *non taxable* exchange transpired and that the basis of the interest received in the Unit is the combined basis of the assets so transferred thereto.” (Italics supplied.)

In subparagraph (v) of paragraph V of the taxpayer’s Petition to the Tax Court [R. 15], the taxpayer alleged the basis of the Commissioner’s determination, and the Commissioner admitted this allegation in his Answer [R. 36]. The language of the admitted allegation is as follows [R. 15]:

“(v) Over the objections of the petitioner the Commissioner has determined that by virtue of the Unit Agreement, and on its effective date (February 1, 1950), the petitioner made *nontaxable exchanges* of its separate interests in the 64 Zone underlying the

area covered by the Unit Agreement, for a single and separate depletable interest (consisting of an undivided interest in the amount of 71.87%) in the properties covered by the Unit Agreement, including the petitioner's own portions of the 64 Zone underlying its Main Property and its Result property, and that the basis to the petitioner for said undivided interest is the combined adjusted bases of its separate interests in the 64 Zone underlying the area covered by the Unit Agreement." (*Italics supplied.*)

The same language as the last quotation was requested by the taxpayer as a finding of fact in its Opening Brief before the Tax Court (page 24, item 30 of said brief), and this requested finding was agreed to by the Commissioner (page 9, item 30, of the Commissioner's Brief in Answer).

Counsel for the taxpayer, in his opening statement before the Tax Court, stated the points at issue [R. 54-56], and counsel for the respondent did not disagree with said statement [R. 57]. The statement of issues was, in material part, as follows [R. 54-56; italics supplied and portions in parenthesis added]:

" . . . The main issue in this case involves the proper interpretation of this unit agreement document . . . The petitioner (Belridge) claims that the agreement simply provides for the co-operative development and operation of the 64 Zone as a unit, and was not a title passing agreement. The respondent (Commissioner) claims that either the unit agreement or the substance or the results of the unit agreement is that an *exchange* of property interest occurred, and that the petitioner (Belridge) made a *non-taxable exchange* of its 64 Zone property interest for an undivided interest in the unit operation

of the 64 Zone, and that by reason of that *exchange*, the new interest acquired took a basis—took the adjusted basis of the properties transferred, and it must be treated in the future as a separate property . . .

“Now, if the Court should decide that the unit agreement resulted in an *exchange* of property interest as the respondent (Commissioner) claims, then the deficiency asserted is in order with a matter of adjustment of some one hundred twenty or one hundred thirty dollars. If the Court should decide that the respondent (Commissioner) is wrong in this main issue and that there was no *exchange* of property interest, then there would still remain for a decision a further issue raised by the respondent (Commissioner) as to the proper method of computing cost depletion on the Result Property. He disputes the method claimed on the return.”

In his opening statement before the Tax Court, counsel for the Commissioner did use the word “merger,” but he used it in the sense that the word conveyed the same meaning as “exchange.” For example [R. 64]:

“The idea of a *merger or exchange*, of course, under the respondent’s viewpoint—what took place was a *like for like exchange*, our old friend 112-B-1, not taxable . . .”

(Note: The reference to “112-B-1” was meant as a reference to Section 112(b)(1) of the Internal Revenue Code of 1939 (App. A, *infra*), which provides, in part, that no gain or loss shall be recognized if productive business property is *exchanged* solely for property of a like kind to be held for productive use in business.)

The taxpayer’s Opening Brief before the Tax Court stated the principal point in controversy in terms of

whether or not an *exchange* of properties or economic interests had taken place (Op. Br., pp. 2, 3, 6, 33). For example, taxpayer stated the following (Op. Br., p. 2; italics and portions in parenthesis supplied):

“*The principal point in controversy*, relative to the amount of the depletion deduction allowable in 1950, is whether or not the petitioner (Belridge), on February 1, 1950, *exchanged* the properties or economic interests which it then owned in the 64 Zone (an oil and gas deposit) for a new and separately depletable property interest in the 64 Zone. The respondent (Commissioner) has determined that the *exchange* took place, and that a new depletable property interest in the 64 Zone was acquired; and the petitioner (Belridge) contests this.”

Before the Tax Court, the taxpayer's argument was necessarily restricted to refuting the Commissioner's determination that an exchange had taken place (taxpayer's Op. Br., pp. 33-58) since the statutory notice of deficiency determination was issued on that basis, the stipulation of facts had been entered into with that issue in view, and the opening statements of counsel stated the issue in terms of exchange or no-exchange.

It is true that the Commissioner's Brief In Answer before the Tax Court contained, in various places, the words (or their derivatives) “*merge, consolidate, or exchange*” in the disjunctive. For example, see pages 3 and 23. However, the Commissioner consistently stated his argument in terms of the “exchange” theory, as is evidenced by the following excerpts from his Tax Court

Brief In Answer (*italics and portions in parenthesis supplied*):

(a) Under the heading "Points Relied Upon:"

"Respondent's (the Commissioner's) position is that, in substance, under the unitization agreement petitioner (Belridge) accomplished a severance of Main's 64 Zone and Result's 64 Zone and, on contributing them to the unit *in return for* an undivided 71.87 percent interest in the units production from the entire 64 Zone pool, petitioner obtained a new 'property' for depletion purposes. Since *such exchange* was non-taxable, petitioner's (Belridge) basis in its new unit property was the sum of the adjusted bases remaining to petitioner (Belridge) in the portions of the Main and Result contributed to the unit." (Br. In Ans., pp. 13-14.)

(b) On page 22(a) of the Commissioner's Brief In Answer, he refers to a case then pending before the Tax Court and states that his "*position there as here is that unitization effects an exchange of properties of like kind.*"

(c) The Commissioner's main argument in his Tax Court Brief (page 28) bears the heading:

"D. Respondent's determination that the unitization accomplished a *tax-free exchange* of economic interests is consistent with his position of long standing, is in accordance with the authorities, and reflects the substance of the matter."

And under the above-quoted heading the subheadings are:

"(1) The 'like kind' term of Section 112(b)(1) I. R. C. of 1939 is applicable.

"(2) *An exchange was accomplished.*" (Br. In Ans., p. 28.)

(d) On pages 32-33 of his Tax Court Brief In Answer, the Commissioner stated:

“Since petitioner (Belridge) obtained its single, 64 Zone unit interest *by reason of a tax-free, Section 112(b)(1), exchange* of two separate 64 Zone interests, petitioner’s basis in its single interest is a transferred basis or the sum of the bases (cost) in what was transferred. Section 114(b)(1) I. R. C. of 1939.”

It is abundantly clear that the Tax Court, with complete justification, conceived the question for decision to be in terms of the “exchange” theory on which the Commissioner’s deficiency determination was based. The head-note (prepared by the Tax Court) to the Findings of Fact and Opinion of the Tax Court [R. 79-81] stated the following [R. 80-81; italics and portion in parenthesis supplied] :

“Respondent (Commissioner) determined that the effect of the unitization agreement was a *tax free exchange under section 112(b)(1)* by petitioner (Belridge) of its operating rights in its two separate properties covered by the agreement for a new depletable interest consisting of its share in unitized oil production . . . Held, petitioner (Belridge) did not *exchange* its interests in its two separate properties for a new depletable interest by participating in the unitization agreement, . . .”

And in the body of its Findings of Fact and Opinion, the Tax Court stated the issues as follows [R. 81-82; italics and portion in parenthesis supplied] :

“The issues to be decided are: (1) Whether, by forming in a unitization agreement for the co-operative operation of all wells in a certain oil pool, peti-

tioner (Belridge) *exchanged* its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under unitized operation; and (2) if not, the amount of the cost depletion allowance which it is entitled to deduct for one of its separate properties covered by the unitization agreement.”

At other places in its opinion, the Tax Court described the theory of the case as follows (italics and portions in parenthesis supplied):

“Respondent (the Commissioner) determined that, by virtue of the unitization agreement, petitioner (Belridge) made *nontaxable exchanges* on February 1, 1950, of its two separate interests in the 64 Zone for a single depletable interest therein . . .” [R. 95.]

“The respondent (Commissioner) contends that the effect of the unitization agreement here was a *tax free exchange* by petitioner (Belridge) of its oil producing rights in the 64 Zone pool underlying its Result Property, and that part of its Main Property subject to the agreement, for a new and separate depletable economic interest consisting of and measured by its 71.87 per cent of oil produced under unitized operation of the field. Section 112(b)(1) provides, in substance, that no gain or loss shall be recognized if property held for productive use in a taxpayer’s trade or business is *exchanged* solely for property of a like kind to be held for a like purpose. *To uphold the respondent’s (the Commissioner’s) determination we must find that the unitization agreement here, preferably both in form and in substance, effected an exchange; and if not in form, certainly in substance.*” [R. 98-99.]

“Neither in those provisions of the agreement, nor elsewhere, do we find any words of conveyance; and, more important, we find no intention on the part of the Participants to *convey or exchange* their economic interests in the 64 Zone.” [R. 100.]

We come next to the Petition for Review [R. 113-117], in which the Commissioner asked your Honorable Court to review the Tax Court decision. Material excerpts from the Petition are as follows (*italics supplied*):

(a) “The Commissioner determined that the effect of the unitization agreement was a *tax-free exchange under Section 112(b)(1)* by taxpayer of its operating rights in its two separate properties covered by the agreement for a new depletable interest consisting of its share in unitized oil production” [R. 114-115.]

(b) “The Tax Court held that taxpayer did not exchange its interest in its two separate properties for a new depletable interest by participating in the unitization agreement

“The issue to be presented for review therefore is: Whether the Tax Court erroneously held that by joining in a unitization agreement for the cooperative operation of all the wells in a certain oil pool, taxpayer did not *exchange* its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under the unitized operation and is, accordingly, entitled to claim percentage depletion on one and cost depletion on the other as previously claimed by taxpayer.” [R. 115.]

(c) “It is the position of the Commissioner that the practical consequence of the transaction here, whereby the unitization was accomplished, was ex-

actly the *same as though formal contracts of exchange had been executed* . . . Furthermore, the practical consequence of a unitization agreement is, therefore, that the owner of a larger interest in a small property which has been *exchanged* for a smaller interest in a larger property no longer looks to the production from the well or wells on his original property but does look to all wells on a unitized block.” [R. 116.]

The Petition for Review was filed October 18, 1957 [R. 117], and was not accompanied by a statement of points to be relied upon. Subsequently, on December 16, 1957 [R. 120], the petitioner here filed his Statement of Points To Be Relied Upon, which included the following, among the twelve points stated [R. 117-118; italics supplied]:

“That the Tax Court of the United States erred:

“1. In failing to hold and decide that taxpayer, as a participant in the unitization agreement, contributed separate operating interest in the 64 Zone in return for 71-87 T (*sic*) of the unit production and thereby, in substance and effect, *merged, consolidated or exchanged* such separate interests for a new depletable interest consisting of an undivided 71.87% interest in 64 Zone mineral property.

“ . . .

“4. In holding and deciding that the taxpayer did not *exchange* its interests in its two separate properties for a new depletable interest by participation in the unitization agreement.”

No. 15887

United States
Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
vs.
BELRIDGE OIL COMPANY,
Respondent.

Transcript of Record

Petition to Review a Decision of the Tax Court
of the United States

FILED

APR - 9 1958

PAUL P. O'BRIEN, CLERK

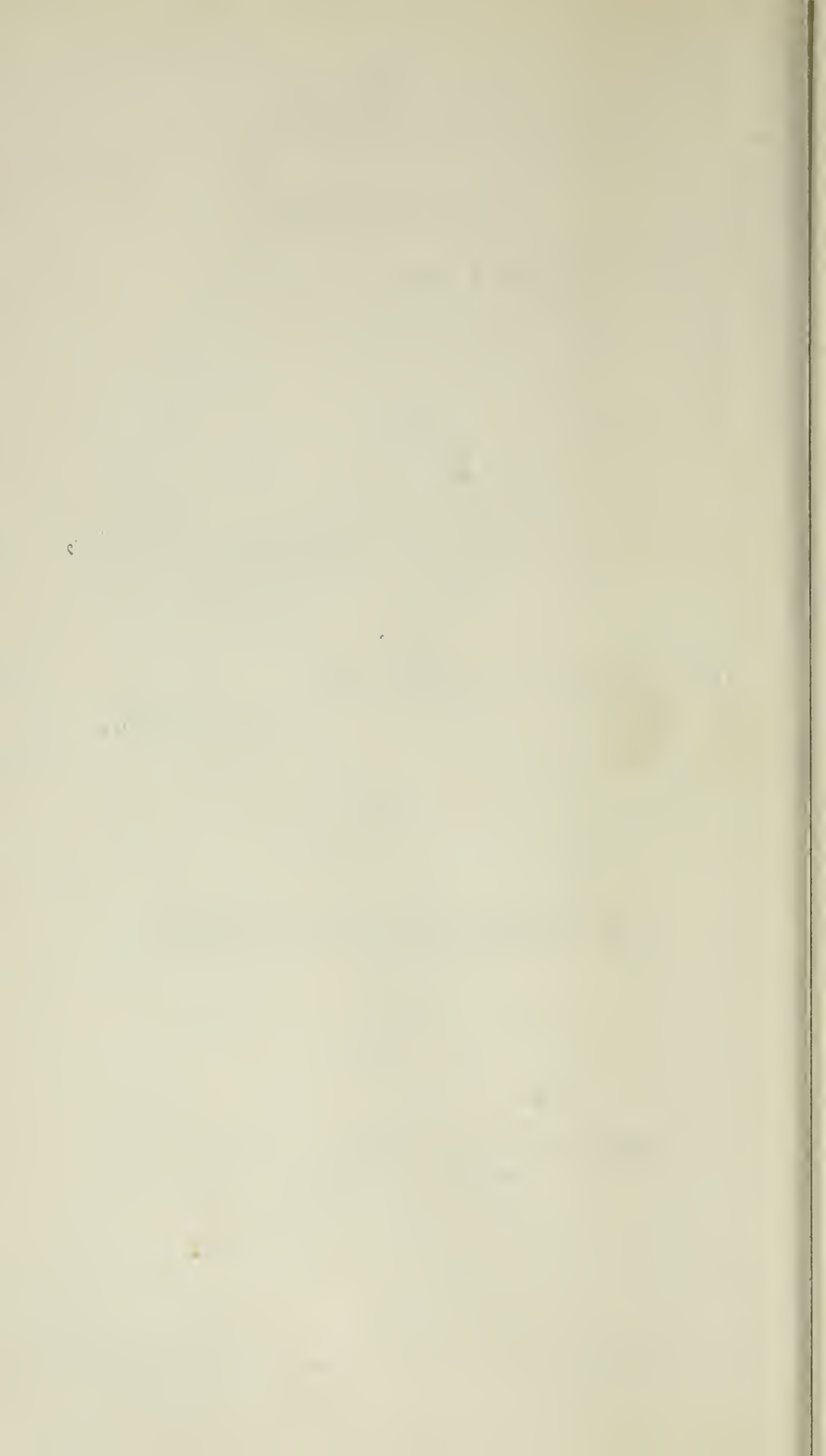
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES

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For Respondent :

RICHARD W. JANES, ESQ.

The Tax Court of the United States

Docket No. 54288

BELRIDGE OIL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1954

Aug. 18—Petition received and filed. Taxpayer notified. Fee paid.

Aug. 18—Copy of petition served on General Counsel.

Oct. 5—Answer filed by General Counsel.

Oct. 5—Request for hearing in Los Angeles filed by General Counsel.

Oct. 7—Notice issued placing proceeding on Los Angeles calendar.

Service of answer and request made.

1955

Oct. 25—Hearing set Jan. 30, 1956, L.A.

1956

Feb. 1—Hearing had before Judge Rice on merits. Stipulation of facts, with exhibits 1-A thru 7-G filed. Petrs. brief 4/2/56; respondent's brief, 5/17/56; reply 6/18/56.

Feb. 17—Transcript of Hearing 2/1/56, filed.

1956

- Apr. 2—Motion for extension to May 11, 1956, to file brief filed by petr. 4/2/56, granted.
- May 15—Brief filed by petitioner. 5/15/56, served.
- June 22—Motion for extension of time to 8/9/56, to file brief filed by respondent. Granted 6/26/56. Served 6/28/56.
- Aug. 6—Motion for extension of time to 9/7/56, to file brief filed by respondent. 8/7/56, granted. Served 8/8/56.
- Sept. 7—Respondent's Brief in answer filed. 9/10/56, served.
- Oct. 5—Motion for extension of time to Nov. 1, 1956, to file reply brief filed by petr. 10/5/56, granted.
- Oct. 9—Oct. 5 motion served.
- Oct. 29—Reply Brief filed by petitioner. 10/29/56, served.

1957

- Mar. 29—Findings of fact and opinion filed. Rice J. Decision will be entered under Rule 50. Served 3/29/57.
- July 24—Agreed computation filed.
- July 26—Decision entered, Murdock J. Div. 3. Served 7/29/57.
- Oct. 18—Petition for review by U. S. Court of Appeals, 9th, filed by respondent.
- Oct. 29—Proof of service of petition for review on L. O. Hopkins filed.
- Oct. 29—Proof of service of petition for review on John B. Milliken, Esq., filed.

1957

- Nov. 15—Motion by respondent for extension of time for filing record on review and docketing pet. for review to Jan. 16, 1958.
- Nov. 15—Order extending time for filing record on review and docketing pet. for review to Jan. 16, 1958.
- Dec. 16—Designation of contents of record on review with proof of service thereon filed by resp.
- Dec. 16—Statement of points to be relied upon filed by resp., with proof of service thereon.
- Dec. 27—Proof of service of statement of points filed.
- Dec. 27—Proof of service of Designation of Contents of Record on review filed.
-

[Title of Tax Court and Cause.]

PETITION FOR A REDETERMINATION OF
INCOME AND EXCESS PROFITS TAX
DEFICIENCY AND FOR REFUND

Belridge Oil Company, the petitioner, hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (bureau symbols A :R :90D : LHP) dated May 28, 1954, and for a determination of refund of taxes, and as a basis of its proceeding the petitioner alleges as follows:

I.

The petitioner is a corporation, duly organized and existing under the laws of the State of California, with its principal office at 815 Edison Building, 601 West Fifth Street, Los Angeles 17, California; and it filed its tax return for the calendar year 1950, the taxable year at issue, with the Director of Internal Revenue for the Los Angeles, California, District.

II.

The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on May 28, 1954, the date that it bears. Attached hereto and marked Exhibit A-1 are excerpts from the "report of examination dated March 12, 1954," referred to in the Statement accompanying the notice of deficiency, which excerpts are material to the issues set out in the assignments of error and are necessary to elucidate the determination of the deficiency and the refund which are in controversy.

III.

The deficiency determined by the Commissioner involves income and excess profits taxes for the calendar taxable year 1950 in the amount of \$43,746.32, and although not all of the Commissioner's adjustments are at issue, the entire dollar amount of the deficiency is in controversy and, in addition, the petitioner claims a refund in the amount of \$8,248.56, or such other amounts as the Court may determine.

IV.

The determination of tax set forth in the notice of deficiency is based on the following errors:

(a) The Commissioner erred in disallowing depletion deductions in the amount of \$56,888.79 (or in any amount) with respect to the deductions for depletion on oil and gas wells claimed by the petitioner on its tax return, and allowable under the provisions of sections 23(m) and 114(b)(3) of the Internal Revenue Code.

(b) The Commissioner erred in his determination that the amount of the depletion deduction on oil and gas wells allowable to the petitioner under section 23(m) of the Internal Revenue Code is limited to \$1,583,784.77.

(c) The Commissioner erred in not determining that the amount of the depletion deduction on oil and gas wells allowable to the petitioner under sections 23(m) and 114(b)(3) of the Internal Revenue Code is at least \$1,674,806.98, an amount which is \$34,133.42 in excess of the aggregate depletion deduction claimed by the petitioner on its return for the year at issue.

(d) The Commissioner erred in not determining that the petitioner is entitled to a refund of income and excess profits taxes for the year at issue in the amount of at least \$8,248.56.

V.

The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The petitioner is engaged principally in the business of producing oil and gas from lands located in Kern County, California. All of the lands hereinafter referred to are located in Kern County, California.

(b) In 1911 the petitioner acquired ownership in fee of some 30,845.96 acres of land (hereinafter called the "Main Property"), and over a period of years two separate producing fields were developed on the Main Property and are known as the North Belridge field and the South Belridge field, respectively.

(c) Prior to 1930 all production obtained from the North Belridge field was from relatively shallow wells (hereinafter sometimes called the "Shallow Zone"), but during the years 1930 to 1942, inclusive, four deeper producing zones underlying the North Belridge field were developed, in addition to the Shallow Zone, as follows:

Zone	Approximate Depth	Year initial wells completed
Temblor Zone	6,000 feet	1930
64 Zone	8,000 feet	1932
R. Zone	7,000 feet	1939
Y. Zone	9,000 feet	1942

The 64 Zone is sometimes called the Wagon Wheel Zone.

(d) In 1945 the petitioner acquired by purchase a producing property, known as the Result property, consisting of approximately 80 acres of land adja-

cent to the petitioner's land in the North Belridge field. Several wells producing from the 64 Zone were on the property when acquired. The Temblor Zone also extends under the Result property.

(e) The 64 Zone does not underlie all of the petitioner's land in the North Belridge area (much less all of its Main Property), but to the extent it does underlie the petitioner's land in the North Belridge area the 64 Zone is the largest developed oil and gas reservoir under such land, and this zone also extends, to some extent, under properties in the North Belridge field owned or operated by five other oil companies, namely, Tide Water Associated Oil Company, Richfield Oil Corporation, The Texas Company, Standard Oil Company of California and Union Oil Company of California.

(f) Prior to October of 1941, production from the 64 Zone by the petitioner and the other oil companies producing from the zone was strictly on a competitive basis. By the year 1938 total oil production from the 64 Zone reached approximately 12,000 barrels a day, but subsequent to 1938 oil production from the zone declined steadily as did the reservoir pressure.

(g) The 64 Zone consists of an elongated dome with a large gas cap circled by a black oil belt which, in turn, is surrounded by water from which a very effective water drive is developed. The gas cap is located principally under the land of the petitioner, and oil can be moved up or down structure from the

petitioner's land by lessening or increasing the gas cap pressure, as the case may be.

(h) Over the period October, 1941 to April 1, 1947, a voluntary gas pressure maintenance program was put in effect by the companies producing from the 64 Zone and a portion of the gas produced with oil from the zone was returned to the reservoir.

(i) In April of 1947, the six companies producing from the 64 Zone abandoned the program of voluntary pressure maintenance and returned to a basis of unrestricted competitive production until February 1, 1950. During this period the six companies obtained approximately the same percentage of total production from the 64 Zone as the "Participating Equities" allotted to them under the "Unit Agreement" hereinafter described.

(j) Prior to February 1, 1950 (but effective on that date) the petitioner and the five other oil companies producing from the 64 Zone, as well as some, but not all, of the owners of royalty interests in the zone, agreed to a plan of production from the 64 Zone on a co-operative basis under that certain agreement entitled "Unit Agreement for the 64 Zone of the North Belridge Oil and Gas Field, Kern County, California," (herein sometimes called the "Unit Agreement") which became effective February 1, 1950, and is to continue as long as production can be obtained from the 64 Zone in quantities determined by the Participants to be sufficient to pay to produce, or until terminated prior to such time by the unanimous consent of the Participants.

(k) The initial "Participants" in the unit operations and their respective "Participating Equities" were as follows:

Participant	Participating Equity
Petitioner	71.87%
Tide Water Associated Oil Company	16.58%
Richfield Oil Corporation.....	4.44%
The Texas Company.....	4.44%
Standard Oil Company of California	1.48%
Union Oil Company of California...	1.19%
	<hr/>
	100.00%

The Unit Agreement defined the term "Participating Equity" to mean that percentage which is the share of the "Unitized Substances" allocated under the agreement to each respective Participant; and the term "Unitized Substances" was defined to mean all oil, gas and associated hydrocarbons produced and saved from the 64 Zone pursuant to the Unit Agreement.

(1) The petitioner was designated as the original Operator under the Unit Agreement and has continued to act as such, and the agreement states the intention of each Participant to establish the Operator as its agent under the agreement for the sole purpose of developing, operating and protecting its interest in the 64 Zone to the extent set forth in the agreement; and the Unit Agreement provides that

the Operator, at the effective date of the agreement, shall take exclusive possession of the operating rights of each Participant in and to the 64 Zone, and enter into the performance of its duties under the agreement to the end that the 64 Zone shall be operated as a unit by a single operator for the benefit of the Participants. The agreement reserves to each Participant whatever rights the Participant may have to develop and produce oil, gas and associated hydrocarbons from any and all formations, zones, or strata other than the 64 Zone, and to use and occupy its land in the area for all purposes not inconsistent with the Unit Agreement.

(m) The Unit Agreement provides that each Participant shall own the percentage of Unitized Substances equal to the Participating Equity of such Participant, and shall accept and take in kind its Participating Equity share of crude oil and wet gas produced and saved from the 64 Zone.

(n) The portions of the petitioner's two properties affected by the Unit Agreement were the 64 Zone underlying the Result property, and the 64 Zone underlying some, but not all, of its Main Property, which latter portion will be hereinafter called the "64 Zone Unitized Area of the Main Property." The Unit Agreement did not affect the other zones underlying the land of the Petitioner, including the Temblor Zone of the Result property, nor the Shallow, Temblor, R. and Y zones underlying the 64 Zone Unitized Area of the Main Property.

(o) The petitioner did not dispose of, sell or exchange with the Operator, or the Participants, or any or all of them, or with any person, any mineral deposit or interest therein, by virtue of its execution of the Unit Agreement or its participation in the unit operation under the agreement.

(p) Both before and after the effective date of the Unit Agreement and operations thereunder, the petitioner owned and continued to own the mineral deposits and all economic interests therein, in the 64 Zone underlying the Result property and in the 64 Zone underlying the 64 Zone Unitized Area of the Main Property.

(q) In the years prior to the year at issue the petitioner and the Commissioner consistently have treated the Main Property (as hereinabove described) as a single property for depletion purposes; and depletion applicable to oil and gas produced from the Main Property (that is, including the petitioner's land in the North and South Belridge fields, and the several producing zones in said fields) has been computed, deducted and allowed on the basis of the adjusted March 1, 1913, value or the statutory percentage of income, whichever was applicable in the tax year involved.

(r) In years prior to the year at issue, the petitioner and the Commissioner consistently have treated the Result property as a separate property apart from the Main Property; and depletion applicable to production from the Result property

(that is, from the several zones underlying it) has been computed, deducted and allowed on the basis of adjusted cost or the statutory percentage of income, whichever was applicable. Depletion based on adjusted cost has consistently been greater than depletion based on the statutory percentage of income.

(s) In its tax return for the year at issue, the petitioner (consistent with past accepted practice) treated the Main Property as a single property for depletion purposes, and computed and deducted depletion applicable to the property on the basis of the statutory percentage of income and in the amount of \$1,568,662.93; that is, on the basis of $27\frac{1}{2}\%$ of \$5,704,228.85, the gross income from the Main Property. The depletion claimed by the petitioner on the Main Property is less than 50% of the net income of the petitioner (computed without allowance for depletion) from the Main Property.

(t) In its tax return for the year at issue, the petitioner (consistent with past accepted practice) treated the Result property as a separate property for depletion purposes, and computed and deducted depletion applicable to the property on the basis of adjusted cost and in the amount of \$72,010.63, based on a cost depletion unit of \$3.43035 a barrel and production in the amount of 20,992.21 barrels of oil.

(u) In the year at issue the adjusted basis of the Result property was \$1,016,863.10; the number of units of mineral remaining as of the taxable year was 201,106 barrels; the cost depletion unit was

\$5.056354 a barrel; the production for the year was 20,992.21 barrels; and the allowable cost depletion was \$106,144.05 rather than the amount of \$72,010.63 claimed on the return, or the amount of \$16,690.52 allowed by the Commissioner.

(v) Over the objections of the petitioner the Commissioner has determined that by virtue of the Unit Agreement, and on its effective date (February 1, 1950), the petitioner made nontaxable exchanges of its separate interests in the 64 Zone underlying the area covered by the Unit Agreement, for a single and separate depletable interest (consisting of an undivided interest in the amount of 71.87%) in the properties covered by the Unit Agreement, including the petitioner's own portions of the 64 Zone underlying its Main Property and its Result property, and that the basis to the petitioner for said undivided interest is the combined adjusted bases of its separate interests in the 64 Zone underlying the area covered by the Unit Agreement.

(w) In his determination of deficiency, the Commissioner has revised the petitioner's computation of percentage depletion on its Main Property by excluding from the Main Property the 64 Zone Unitized Area of the Main Property, and the Commissioner has treated the remainder of the Main Property (including the petitioner's land in the North and South Belridge fields, and the several producing zones, other than the 64 Zone, underlying said land) as a separate property for the purpose of computing the percentage depletion allowed by him

with respect to all production from the Main Property other than the 64 Zone Unitized Area of the Main Property.

(x) The effect of the Commissioner's determination in this respect is as follows:

	Gross Income	27½% Depletion
Main Property per return.....	\$5,704,228.85	\$1,568,662.93
Less: 64 Zone Unitized Area of		
Main Property	1,019,045.48	280,237.50
	<hr/>	<hr/>
Main Property exclusive of 64		
Zone Unitized Area	\$4,685,183.37	\$1,288,425.43

(y) In his determination of deficiency, the Commissioner has revised the petitioner's computation of cost depletion on the Result property and disallowed \$55,320.11 of the cost depletion in the amount of \$72,010.63 claimed on the return. In making this determination the Commissioner treated the Result property as a separate property for cost depletion purposes only for the month of January, 1950, and he allowed cost depletion in the amount of \$16,690.52 by applying a cost depletion unit of \$5.0121667 a barrel to January production in the amount of 3,330 barrels.

(z) In his determination of deficiency, the Commissioner has treated as a single and separate depletable property the entire 64 Zone of the petitioner included in the Unitized Area under the Unit Agreement and has determined allowable depletion in the amount of \$278,668.82 as follows:

Gross Income	\$1,108,003.19
27½% of gross income.....	304,700.88
Depletion limited to 50% of net income or	278,668.82

(aa) In his determination of deficiency, the Commissioner has effectively disallowed depletion deductions in the aggregate amount of \$56,888.79, which the petitioner had deducted on its return, as follows:

Claimed on return :

(1) Percentage depletion on the 64 Zone Unitized Area of Main Property	\$280,237.50	
(2) Cost depletion on Result property	72,010.63	\$352,248.13
	<hr/>	

Allowed by Commissioner :

(1) Percentage of net income depletion applicable to Unit Agreement operation	\$278,668.82	
(2) January cost depletion on Result	16,690.52	295,359.34
	<hr/>	<hr/>

Depletion disallowed	<hr/>	\$ 56,888.79
		<hr/>

(bb) The petitioner did not acquire a new economic interest in a separate mineral deposit and property by virtue of the Unit Agreement and the unit operations.

(cc) The petitioner did not sell, exchange or dispose of any part of the mineral deposits underlying its Main Property, nor any economic interest therein, by virtue of the Unit Agreement and the

unit operations; and the petitioner is permitted and required to compute depletion on its Main Property as a single, separate property in accordance with the treatment consistently followed by it in prior years and accepted by the Commissioner for those years.

(dd) The petitioner did not sell, exchange or dispose of any part of the mineral deposits underlying its Result property, nor any economic interest therein, by virtue of the Unit Agreement and the unit operations; and the petitioner is permitted and required to compute depletion on its Result property as a single, separate property in accordance with the treatment consistently followed by it in prior years and accepted by the Commissioner for those years.

(ee) The aggregate of the depletion allowable to the petitioner on its Main Property and its Result property for the year at issue is \$1,674,806.98, an amount which is \$34,133.42 in excess of the aggregate depletion deducted on its return.

(ff) The Commissioner erred in limiting the allowable depletion to \$1,583,784.77.

(gg) Pursuant to an extension of time for filing, the petitioner filed its return for the year at issue on May 5, 1951, and paid income and excess profits taxes in the amount of \$1,019,485.40, of which the final installment of \$203,897.08 was paid on December 7, 1951.

(hh) On November 2, 1953, the petitioner and the Commissioner executed an agreement, pursuant

to section 276(b) of the Internal Revenue Code, extending to June 30, 1955, the time within which the Commissioner might assess the tax for the year.

(ii) The petitioner overpaid its taxes for the year at issue in the amount of \$8,248.56. No refund claim was filed by the petitioner, and no part of the amount overpaid has been paid or credited to the petitioner.

(jj) The taxes overpaid by the petitioner were paid within two years before the execution by the petitioner and the Commissioner of said agreement extending the time within which the Commissioner might assess the tax for the year; and said agreement was executed within three years from the time the tax return was filed by the petitioner.

(kk) The petitioner is entitled to a refund of income and excess profits taxes paid by it for the calendar taxable year 1950 in the amount of \$8,248.56.

Wherefore, the petitioner prays that the Court will hear the proceedings and determine under Rule 50—

(1) That there is no deficiency in income and excess profits taxes for the calendar taxable year 1950.

(2) That the petitioner has overpaid its income and excess profits taxes for the year in the amount of \$8,248.56 or such other amount as the Court may determine.

(3) That the tax overpaid was paid within two years before the execution by the petitioner and the Commissioner of the agreement pursuant to section 276(b) of the Internal Revenue Code to extend to June 30, 1955, the time within which the Commissioner might assess the tax; and that said agreement was executed within three years from the time the tax return was filed by the petitioner; or otherwise determine that the refund is within the period for refunds.

(4) That the petitioner is entitled to such other and further relief as the Court may deem proper.

Respectfully submitted,

/s/ JOHN B. MILLIKEN,

/s/ RALPH KOHLMEIER,

/s/ FRANK W. CLARK, JR.,

/s/ HARRISON HARKINS,

Counsel for the Petitioner.

Of Counsel:

/s/ L. A. LUCE.

Duly verified.

EXHIBIT A

U. S. Treasury Department
Internal Revenue Service
Chief, Audit Division
P. O. Box 231—Main Office
Los Angeles 53, California

May 28, 1954

District Office of
Director of Internal Revenue

In Replying Refer to:

A:R:90D:LHP

MI. 8111, Ext. 381

Belridge Oil Company,
601 West Fifth Street, Room 815,
Los Angeles 17, California.

Gentlemen:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1950, discloses a deficiency or deficiencies of \$43,746.32, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the

deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the District Director of Internal Revenue, Audit Division, P. O. Box 231, Main Office, Los Angeles 53, Calif. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earlier.

Very truly yours,

T. COLEMAN ANDREWS,
Commissioner;

By /s/ R. A. RIDDELL,
District Director of
Internal Revenue.

Enclosures:

Statement

Form 1276

Agreement Form

Statement

A:R:90D:LHP

Belridge Oil Company
601 West Fifth Street, Room 815
Los Angeles 17, California

Tax Liability for the Taxable Year Ended
December 31, 1950

	Liability	Assessed	Deficiency
Income and excess profits tax	\$1,063,231.72	\$1,019,485.40	\$43,746.32

In making this determination of your income and excess profits tax liability, careful consideration has been given to the report of examination dated March 12, 1954.

A copy of this letter and statement has been mailed to your representative, Mr. John B. Milliken, 650 South Spring Street, Los Angeles 14, California, in accordance with the authority contained in the power of attorney executed by you.

Adjustments to Net Income

	Income Tax Net Income	Excess Profits Net Income
Net income as disclosed by return	\$2,252,950.65	\$2,191,291.14
Additional income and unallowable deductions:		
(a) Capital gain	41,834.53	—
(b) Depletion	56,888.79	56,888.79
(c) State franchise tax	2,709.87	2,709.87
Total	\$2,354,383.84	\$2,250,889.80
Additional deductions:		
(d) Depreciation	3,834.83	3,834.83
Net income adjusted	\$2,350,549.01	\$2,247,054.97

Explanation of Adjustments

(a) In your return you have treated the amount received as cash equalization payments under a certain Unit Agreement for the 64 Zone as a reduction of the basis of the assets transferred

to the Operator under the said agreement. It is held that such amount, or \$41,834.53, constitutes a capital gain within the meaning of sections 112(c)(1) and 117(j) of the Internal Revenue Code and it is accordingly added to the income reported in your return.

(b) The amount of depletion allowable under section 23(m) of the Internal Revenue Code has been determined to be \$1,583,784.77. Since you claimed in your return a deduction for depletion in the amount of \$1,640,673.56 the difference, or \$56,888.79, is disallowed.

(c) It has been determined that the deduction allowable for California franchise tax for the taxable year ended December 31, 1950, is the amount of \$73,537.83, instead of \$76,247.70, the amount deducted in your return. The excess of \$2,709.87 is disallowed.

(d) It has been determined that the deduction allowable for depreciation, under section 23(1) of the Internal Revenue Code, is the amount of \$163,594.77. Since you claimed in your return a deduction for depreciation in the amount of \$159,759.94 the difference, or \$3,834.83, is allowed as a deduction.

Computation of Excess Profits Credit

There is determined an excess profits credit, based on invested capital, in the amount of \$1,596,765.67, in lieu of \$1,606,244.81, the amount claimed in your return, as shown in the following:

Invested capital as disclosed by return	\$16,328,060.07
Decrease:	
(a) Equity capital at the be- ginning of the taxable year	118,489.24
Invested capital, as adjusted	<u>\$16,209,570.83</u>
Excess profits credit:	
12% of \$5,000,000.00	\$ 600,000.00
10% of \$5,000,000.00	500,000.00
8% of \$6,209,570.83	<u>496,765.67</u>
Excess profits credit, as determined	\$ 1,596,765.67

Explanation

(a) Your equity capital at the beginning of the taxable year has been determined in the amount of \$16,209,570.83, in lieu of \$16,328,060.07, the amount shown by your return, a decrease of \$118,489.24.

Computation of Tax

Net income adjusted	\$2,350,549.01
Income subject to normal tax and surtax	\$2,350,549.01

Computation Under General Rule
(Sections 13 and 15, I.R.C.)

Income tax (combined normal tax and surtax) :	
42% of \$2,350,549.01	\$ 987,230.58
Subtract	4,750.00
<hr/>	
Total income tax under general rule	\$ 982,480.58

Computation of Alternative Tax
(Section 117(e), I.R.C.)

Income as above	\$2,350,549.01
Less: Excess of net long-term capital gain over net short- term capital loss	103,494.04
<hr/>	
Ordinary net income	\$2,247,054.97
Income tax (combined normal tax and surtax) :	
42% of \$2,247,054.97	\$ 943,763.09
Subtract	4,750.00
<hr/>	
Partial tax	\$ 939,013.09
Plus: 25% of \$103,494.04	25,873.51
<hr/>	
Alternative tax	\$ 964,886.60

Tax Under Section 430, I.R.C.

Excess profits net income	\$2,247,054.97
Less: Excess profits credit	1,596,765.67

Adjusted excess profits net income	\$ 650,289.30
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.30% of \$650,289.30 (Limitation under Sec. 430(a)

(2) not applicable)	\$ 195,086.79
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Number of days in taxable year	365
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Number of days after June 30, 1950.....	184
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Excess profits tax:

184/365 x \$195,086.79	\$ 98,345.12
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Excess profits tax under section 430	\$ 98,345.12
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Summary

Income tax (alternative tax)	\$ 964,886.60
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Excess profits tax	98,345.12
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Correct income and excess profits tax liability	\$1,063,231.72
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Income and excess profits tax assessed:

Original, account No. 4180941	\$1,019,485.40
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Deficiency of income and excess profits tax	\$ 43,746.32
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Name of Taxpayer Belridge Oil Company

Form No. 1
 TREASURY DEPARTMENT
 INTERNAL REVENUE SERVICE
 (Revised March 1951)

Index:

Date of Report February 24, 1954 MAR 12 1954 19

Examining Officer Walfred E. Runston

STATEMENT OF TOTAL TAX LIABILITY

YEAR	LIABILITY		PREVIOUSLY ASSESSED*		ADJUSTMENTS PROPOSED IN THIS REPORT			
	Tax	Penalty	Tax	Penalty	Tax		Penalty	
					Deficiency	Overassessment	Deficiency	Overassessment
INCOME TAX								
1950	063 734.72		019 485.40		43 746.32			
TOTAL	063 734.72		019 485.40		43 746.32			

Belridge Oil Company

1950

PRELIMINARY STATEMENT

The causes of the net deficiency in income taxes recommended herein are due to changes in the allowable depletion arising from Unitization of the North Belridge Oil field in part; treatment of the case boot or equilization payments received upon unitization of the aforementioned oil field as a capital gain within the meaning of Section 112(c)(1) of the Internal Revenue Code; changes in the allowable depreciation; and a reduction of the State Franchise Tax accrual.

Belridge Oil Company

1950

Schedule 1(a)

EXPLANATION OF ITEMS

Item (a) Depletion

56 888.79.

Under that certain Unitization Agreement entered into on February 1, 1950 it is recommended herein that a non taxable exchange transpired and that the basis of the interest received in the Unit is the combined basis of the assets so transferred thereto. See Exhibit I for detail analysis and commentary upon this adjustment.

EXHIBIT A-1

EXHIBIT I

Los Angeles Division

Engineers Report

March 31, 1952

Belridge Oil Company,
Edison Building,
Los Angeles, California.

Taxable Year 1950

Depletion Denied	\$56,888.79
Capital Gain	41,834.53
Additional Depreciation	3,834.83

Discussion of Adjustments

Depletion

The taxpayer, organized in 1911, owns approximately 30,000 acres in fee simple, located in Kern County, California, and including major portions of both the North and South Belridge Oil Fields.

Deeper horizons known as the "64 Zone" were found in the North Belridge Field in 1932 where the taxpayer owned important productive properties.

In 1945 Belridge acquired the lessee and royalty interests in the Continental-Result lease which was a strategically located property in the North Belridge area and productive in the 64-zone and important to control of the gas cap in this zone.

The consideration paid for the Result property by Belridge was a fixed number of barrels of oil of average field gravity, payable at a monthly rate over a period of years and at the field posted price per barrel.

Acquisition of all interests except the lessee share was accomplished and payments for this larger interest have continued in each year at increased prices much in excess of the starting price.

This purchase results in a very high unit cost base for depletion purposes since the property was acquired in contemplation of a unitization agreement and estimated oil reserves of the property itself do not appear to justify the total consideration which is being paid.

During 1950 unitization was effected and the taxpayer contributed all its properties productive in the 64-zone in exchange for a 71.87% interest in the unitized area or pool production.

In all prior years the taxpayer has consistently treated its fee holdings as a single property for depletion purposes regardless of the fact that two large oil fields were included and production was obtained from various stratigraphic depths from horizons which were of different geological age and character.

Following unitization the taxpayer has continued to claim high cost depletion on the Result property as a separate depletable interest, outside of the unit.

Prior to 1950 the Result lease was correctly depleted as a separate property and the unitization of the mineral interests is recognized as a nontaxable exchange whether effected by cross-assignments or agreement.

It is the opinion of this officer that the pooling agreement ended in a merger of all the taxpayers 64-zone wells into a single unit for depletion purposes, regardless of the number of properties contributed, since regardless of the legal form the taxpayer in substance exchanged its fee lands and the Result property for a 71.87% undivided interest or share of the unitized block.

In the event of an alternate solution of this issue which would recognize the separate properties contributed by Belridge to the unitization, it would appear necessary to allocate the adjusted basis remaining in the Result over the properties acquired upon a value basis. This procedure would dilute the cost depletion unit over the oil reserves established for parts of several sections of developed lands and the wells thereon. E. C. Laster, 43-BTA-159 (1940).

No attempt has been made to establish values for allocation purposes since the fee properties contributed by Belridge were all over depleted and their value was so far in excess of the value of the Result lands that it is obvious that no tax-wise effect would be had.

Attention is also directed to the fact that no attempt has been made to transmute any part of the adjusted basis of tangibles into the depletable basis by allocations upon a value basis.

Depletion claimed upon the high cost basis of the Result property has been denied following the unitization.

Capital Gains & Depreciation

Due to the advanced stage of the taxpayers development program as compared to other operators joining into the unitization, Belridge received \$41,834.53 boot money or cash in equalization of the total value of all tangibles involved in the exchange.

This amount has been treated as capital gain since it is less than the indicated profit computed as the difference between the taxpayers adjusted basis and the total value received in the exchange.

The taxpayer treated the boot money received as a reduction of its adjusted basis in tangible assets by the process of negative depreciation provisions deducted from total provision for the year 1950 and following years and until the amount of the boot money had been offset by an equal reduction of the total adjusted basis.

The negative depreciation has been restored to the provision allowable for the year 1950 in the amount of \$3,834.83.

Depletion, depreciation and capital gain adjustments are shown in detail by exhibits which accompany the R.A.R.

Unadjusted Items

All other engineering features involved in the return were verified and found to be reasonable and acceptable and accordingly no further adjustments are recommended to the deductions claimed.

R. F. WHITE, E.R.A.

Received: L.W.P 2/12/54.

Approved:

/s/ P. WILLIAMS,
Chief Natural Resources
Section.

Received and filed August 18, 1954, T.C.U.S.

Served August 18, 1954.

[Title of Tax Court and Cause.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue Service, for answer to the petition of the above-named taxpayer, admits and denies as follows:

I, II and III.

Admits the allegations contained in paragraphs I, II and III of the petition.

IV.

(a) to (d), inclusive. Denies the allegations of error contained in subparagraphs (a) to (d), inclusive, of paragraph IV of the petition.

V.

(a) to (f), inclusive. Admits the allegations contained in subparagraphs (a) to (f), inclusive, of paragraph V of the petition.

(g) Admits the allegations contained in subparagraph (g) of paragraph V of the petition, excepting that respondent denies that oil can be moved up or down structure from the petitioner's land by lessening or increasing the gas cap pressure, as the case may be.

(h) to (n), inclusive. Admits the allegations contained in subparagraphs (h) to (n), inclusive, of paragraph V of the petition.

(o) and (p) Denies the allegations contained in subparagraphs (o) and (p) of paragraph V of the petition.

(q) to (t), inclusive. Admits the allegations contained in subparagraphs (q) to (t), inclusive, of paragraph V of the petition.

(u) Denies the allegations contained in subparagraph (u) of paragraph V of the petition.

(v) to (z), inclusive. Admits the allegations contained in subparagraphs (v) to (z), inclusive, of paragraph V of the petition.

(aa). Admits the allegations contained in subparagraph (aa) of paragraph V of the petition, excepting that respondent denies that petitioner had claimed on its return \$280,237.50 for depletion as alleged.

(bb) to (ff), inclusive. Denies the allegations contained in subparagraphs (bb) to (ff), inclusive, of paragraph V of the petition.

(gg) and (hh). Admits the allegations contained in subparagraphs (gg) and (hh) of paragraph V of the petition.

(ii) Denies the allegations contained in the first sentence of subparagraph (ii) of paragraph V of the petition; for lack of sufficient information presently available, denies the remaining allegations contained in said subparagraph.

(jj) Admits that said agreement was executed within three years from the time the tax return was filed by the petitioner; for lack of sufficient information presently available, respondent denies the remaining allegations contained in subparagraph (jj) of paragraph V of the petition.

(kk) Denies the allegations contained in subparagraph (kk) of paragraph V of the petition.

VI.

Denies each and every allegation contained in the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

/s/ DANIEL A. TAYLOR, R.E.M.,
Chief Counsel,
Internal Revenue Service.

Of Counsel:

MELVIN L. SEARS,
Regional Counsel;
E. C. CROUTER,
Assistant Regional Counsel;
R. E. MAIDEN, JR.,
Special Asst. to the
Regional Counsel;
RICHARD W. JANES,
Special Attorney,
Internal Revenue Service.

[Title of Tax Court and Cause.]

STIPULATION OF FACTS

It Is Hereby Stipulated and Agreed by the parties to this proceeding, through their respective counsel of record, that the facts stated and incorporated in this stipulation are true and may be found as facts by the Court, subject to the rights of either party to introduce any other and further evidence which is not contrary to the facts herein stipulated.

1. The petitioner is a corporation, duly organized and existing under the laws of the State of California, with its principal office at 1300 West Fourth Street, Los Angeles, California; and it filed its tax return for the calendar year 1950, the taxable year at issue, with the Director of Internal Revenue for the Los Angeles, California, District.

2. The statutory notice of determination of deficiency against petitioner for the year at issue was mailed to petitioner on May 28, 1954.

3. Accompanying this stipulation, marked Exhibit 1-A, and made a part hereof, is a copy of the tax return filed by the petitioner for the calendar year 1950, the year at issue.

4. Accompanying this stipulation, marked Exhibit 2-B, and made a part hereof, is a copy of the report of Examining Officer Walfred E. Runston, dated March 12, 1954, which is the "report of examination dated March 12, 1954" referred to in the

“Statement” which accompanied the statutory notice of determination dated May 28, 1954.

The parties agree to the introduction of Exhibit 2-B solely for the purpose of showing the basis used by the respondent in determining the deficiency here at issue.

5. Accompanying this stipulation, and made a part hereof, are the following exhibits:

Exhibit 3-C

A copy of the document entitled “Unit Agreement for the 64 Zone of the North Belridge Oil and Gas Field, Kern County, California,” together with the six exhibits (A to F, inclusive) referred to in the Agreement and reproduced as part of Exhibit 3-C. The original of Exhibit 3-C was executed by the parties, and on the dates, shown on pages 33 and 34, and the two unnumbered pages which follow page 34, of said exhibit.

Exhibit 4-D

A copy of the document entitled, “Supplemental Agreement to Unit Agreement for the 64 Zone of the North Belridge Oil and Gas Field, Kern County, California.” The original of this exhibit was executed by the parties listed on pages 12 and 13 of the exhibit.

Exhibit 5-E

A copy of the document entitled “Agreement,” dated January 17, 1950, the original of

which was executed by the parties listed on pages 1 and 2 of the exhibit.

6. The original of the document which is reproduced on page 45 of Exhibit 3-C (that is Exhibit F of said exhibit) was executed by R. D. Bush, Oil and Gas Supervisor of the State of California, on October 27, 1949.

7. A number of the originals of the document entitled, "Lessors' and Royalty Owners' Consent" (which is reproduced as Exhibit E on pages 41-44 of Exhibit 3-C) were executed by lessors and royalty owners who possessed interests in the 64 Zone covered by the leases held by The Texas Company and Union Oil Company of California; and each of the two named companies endorsed its acceptance on the documents executed by those with interests in the 64 Zone covered by its lease.

No "Lessors' and Royalty Owners' Consent" was executed or endorsed by the owners of fee properties, that is, petitioner, Tide Water Associated Oil Company, Richfield Oil Corporation, and Standard Oil Company of California.

8. At various places in Exhibit 3-C reference is made to a "Belridge Lease" held by Union Oil Company of California. The quoted words are descriptive only, and petitioner did not execute, or participate in the execution of the "Belridge Lease" to Union Oil Company.

9. On page 35 of Exhibit 3-C (Exhibit A of Exhibit 3-C), the various dots and stars, next to each of

which is printed a small numeral, represent wells drilled to the 64 Zone.

Tide Water Associated's wells 1 and 35 in Section 21, and petitioner's well 8 in Section 27 were "dual wells," drilled and operating in both the 64 Zone and the R Zone. There was and is a physical separation of the production from the two zones, and production from the R Zone was obtained through the space between the wall of the well casing and the wall of a tube inside the casing, and production from the 64 Zone was obtained from said inner tubing.

After Exhibit 3-C went into effect, the "Operator" under said agreement made a monthly service charge to Tide Water Associated and Belridge covering operations of the dual wells in the R Zone.

10. Accompanying this stipulation, marked Exhibit 6-F, and made a part hereof, is a contour map of the 64 Zone. However, the various dots and symbols, next to each of which is printed a small numeral, represent wells drilled to all five producing zones in the area, and are not restricted to wells drilled to the 64 Zone. The exhibit on page 35 of Exhibit 3-C identifies the wells drilled to the 64 Zone.

11. After Exhibit 3-C went into effect, petitioner continued to operate and produce from the Shallow, Temblor, R, and Y Zones underlying the same surface area of its Main Property as that covered by Exhibit 3-C. Likewise Richfield Oil Corporation, Tide Water Associated Oil Company, The Texas

Company, and Union Oil Company of California continued to operate and produce from one or more of said four zones underlying the same surface area of their respective properties as were covered by Exhibit 3-C.

In 1954, petitioner resumed production from the Temblor Zone of its Result Property. No production was taken from the Temblor Zone of the Result Property in the years 1949 to 1953, inclusive.

12. At February 1, 1950, the perimeter of the gas cap of the 64 Zone was approximately within the 7,500-foot contour shown on Exhibit 6-F.

13. On Exhibit 6-F, the surface boundaries of the petitioner's Result Property are shown by the rectangle, the four corners of which are marked by red pencil.

14. After Exhibit 3-C went into effect, the Operator under the agreement injected gas into the 64 Zone through several of the existing wells which extended into the Zone. None of the gas injection wells are located on the Result Property.

15. No Federal income tax return, partnership return, or fiduciary return was filed by or for the unit operation conducted under the provisions of Exhibit 3-C for the year 1950, or for any subsequent year up to the date of this stipulation. And as of the date of this stipulation, the petitioner (in its own right and as the operator under Exhibit 3-C) has not received any demand or request that any such return be filed by or for the unit operation.

16. ~~For the purposes of this proceeding, it is agreed that cost depletion, if any, allowable to petitioner, has been and is to be computed on the basis of oil production only, as distinguished from production of gas, gasoline, butane, and liquid petroleum gas products.~~

16. Prior to the effective date of Exhibit 3-C, both the commissioner and the petitioner computed cost depletion respecting Result upon the basis of oil reserves and oil production only, exclusive of other hydrocarbon products such as gas, butane, etc. Only with respect to the tax year involved in this proceeding, it is agreed by the parties that if cost depletion is determined to be allowable to Result as a separate property, such depletion may be similarly computed on the basis of oil reserves and oil production only, exclusive of other products.

16a. Should the petitioner be successful in maintaining that cost depletion is allowable to Result as a separate property, it is further expressly agreed that each party may be free to maintain that for subsequent years a different basis may be used in computing cost depletion for Result.

17. For the purposes of this proceeding, it is agreed that prior to the year 1950, the petitioner had completely recovered, through depletion allowances, its tax basis for its Main Property, as distinguished from its Result Property.

18. Petitioner acquired the working interest and the landowner and royalty owners' rights in the

Result property as of September 1, 1944. Accompanying this stipulation, marked Exhibit 7-G and made a part hereof, is a copy of the agreement pursuant to which petitioner acquired the working interest. The various landowner and royalty interests were acquired concurrently, calling for cash payments of a similar nature, measured by the cash value of stated numbers of barrels of oil, valued as of the due dates of the installment payments.

Although the Result property contained and contains reserves of wet gas as well as oil reserves, the measure of the total consideration which petitioner obligated itself to pay for the property was the cash value of 820,107 barrels of oil.

Subsequent to the year at issue, and prior to the date of this stipulation, petitioner has completed payment for the Result property at a cost (for mineral rights, equipment, and land) as follows:

Payments to Continental Oil

Company\$1,727,284.20

Payments for landowner and

royalty interests 184,443.97

Other costs 1,225.64

Total\$1,912,953.81

19. The oil reserves of the Result property as of September 1, 1944 (as agreed to by the petitioner and the respondent), and the oil production from the property through January 31, 1950, are as follows:

	Barrels of Oil		
	64 Zone	Temblor Zone	Total
Reserve at 9/1/44	350,349	39,247	389,596
Deduct: Production			
9/1/44 to 12/31/44	19,349	5,247	24,596
Year: 1945	23,645	1,869	25,514
1946	33,324	—0—	33,324
1947	39,998	1,628	41,626
1948	25,908	6,705	32,613
1949	30,817	—0—	30,817
	173,041	15,449	188,490
Remaining Reserve, 1/1/50	177,308	23,798	201,106
Deduct: January, 1950 Prod.	3,330	—0—	3,330
Remaining Reserve, 1/31/50	173,978	23,798	197,776

20. Prior to the effective date of Exhibit 3-C, the petitioner and the respondent have consistently followed the procedure of lumping oil production from both the 64 and Temblor Zones of the Result property in computing cost depletion on the Result property.

21. The basis for depletion of the Result property, as provided in Section 114(b) of the Internal Revenue Code of 1939, was \$1,007,976.81 at January 1, 1950. Subsequent to January 31, 1950, and prior to December 31, 1950, the cost to the petitioner of the Result property was increased in the amount of \$8,886.29, by reason of increases in the posted field price for oil which increased the cash outlay which petitioner was obligated to make for the purchase of the Result property.

On its 1950 tax return (Exhibit 1-A), petitioner had erroneously reported \$689,863.29 as the basis for depletion of the Result property.

22. During the period of unit operations under Exhibit 3-C (that is, from February 1, to December 31, 1950, inclusive), a total of 428,139 barrels of oil were produced from the 64 Zone as follows:

(a) 21,672 barrels from wells located on the surface area of the Result property.

(b) 215,390 barrels from wells located on the surface area of the petitioner's Main Property.

(c) 191,077 barrels from wells located on the surface area of the other participants who were parties to Exhibit 3-C.

23. Of the total oil production from the 64 Zone for the period February 1, to December 31, 1950 (428,139 barrels), 71.87%, or 307,704 barrels, was allotted to petitioner under Exhibit 3-C, and 28.13%, or 120,435 barrels, was allotted to the other participants under Exhibit 3-C.

24. The production of oil from the Result property for the period April 1, 1947, to January 31, 1950, was as follows:

	Barrels of Oil		
	64 Zone	Temblor Zone	Total
4/1/47 to 12/31/47	30,206	1,628	31,834
Year: 1948	25,908	6,705	32,613
1949	30,817	-0-	30,817
January, 1950	3,330	-0-	3,330
Total	90,261	8,333	98,594

The total Result oil production from the 64 Zone for this period (90,261 barrels) was:

(a) 4.29% of the petitioner's total oil production from the same Zone for the same period (2,102,158 barrels); and

(b) 2.77% of the total oil production from the same Zone for the same period (3,255,417 barrels).

25. The production of oil from the petitioner's Main Property for the period April 1, 1947, to January 31, 1950, was as follows:

	Barrels of Oil		
	64 Zone	All Other Zones	Total
4/1/47 to 12/31/47	773,704	460,375	1,234,079
Year: 1948	693,361	940,791	1,634,152
1949	506,421	994,946	1,501,367
January, 1950	38,411	88,268	126,679
Total	2,011,897	2,484,380	4,496,277

26. During the period February 1, 1950, to December 31, 1950, the actual oil production from wells on the surface areas of the petitioner's Result property and its Main Property was as follows:

Result Property:

	Barrels of Oil		
	64 Zone	Tremblor Zone	Total
2/1 to 12/31/50	21,672	-0-	21,672

Main Property:

	Barrels of Oil		
	64 Zone	All Other Zones	Total
2/1 to 12/31/50	215,390	1,170,355	1,385,745

27. During the year 1949, oil production from the 64 Zone of the Result property (30,817 barrels) was:

(a) 5.74% of the petitioner's total oil production for 1949 from the 64 Zone (537,238 barrels); and

(b) 3.55% of the total oil production from the 64 Zone for 1949 (867,915 barrels).

28. During the month of January, 1950, oil production from the 64 Zone of the Result property (3,330 barrels) was:

(a) 7.98% of the petitioner's total oil production for the same month from the 64 Zone (41,741 barrels); and

(b) 5.20% of the total oil production from the 64 Zone for the same month (64,010 barrels).

29. On its return for the calendar year 1950, the petitioner allotted 17,662 barrels of unit oil production from the 64 Zone, for the period February 1 to December 31, 1950, to the Result property, on the basis of the relationship which actual Result 64 Zone oil production for the competitive year 1949, bore to the petitioner's total oil production from the 64 Zone for the same year.

The allotted production was computed as follows:

1949 Result 64 Zone oil production as a percentage of petitioner's 1949 total 64 Zone oil production	5.74%
64 Zone oil production allotted to petitioner under Exhibit 3-C, for the period February 1 to December 31, 1950 (71.87% of 428,139 barrels, the actual unit production)	307,704 barrels
5.74% of 307,704 equals unit production allotted to Result property, or	17,662 barrels (in round figures)

Or, expressing the same data as a percentage of total unit production, the computation would be as follows:

5.74% times 71.87% equals 4.125338%.

4.125338% of 428,139 equals 17,662 barrels, in round figures.

30. On its return for the calendar year 1950, the petitioner computed the cost depletion claimed by it, with respect to the Result property, as follows:

(a) Depletable basis claimed on return	\$689,863.29	
(b) Oil reserve (barrels)	201,106	
(c) Unit cost ((a) ÷ (b))	\$	3.43035
(d) Production (barrels):		
January, 1950	3,330	
Allotted unit production (See Paragraph 29 of Stipulation)	17,662.21	20,992.21
<hr/>		
(e) Cost depletion ((c) times (d))	\$	72,010.63

31. In his determination of the deficiency at issue, the respondent computed the cost depletion allowable on the Result property as follows:

(a) Depletable basis	\$1,007,976.81	
(b) Oil reserve (barrels)	201,106	
(c) Unit cost ((a) ÷ (b))		5.0121667
(d) Production (barrels):		
January, 1950	3,330	
(e) Cost depletion ((c) times (d))	\$	16,690.52

32. For the purposes of this proceeding, it is agreed that at January 1, 1950, the oil reserves, in terms of the number of units of oil remaining as of

the taxable year, were 3,100,000 barrels for the entire 64 Zone and 1,890,000 barrels for the 64 Zone of the petitioner's Main Property. During the month of January, 1950, 64,011 barrels of oil were produced from the 64 Zone.

33. The petitioner, aside from the claim of over-payment made in its petition, has not filed a refund claim for the year at issue; and no part of the income and excess profits taxes of \$1,019,485.40, paid by it for the year at issue, has been refunded or otherwise credited to the petitioner.

34. Petitioner paid a \$203,897.08 installment of its 1950 taxes on December 7, 1951, which amount was paid within two years before the November 2, 1953, execution by the petitioner and the respondent of the extension agreement pursuant to Section 276(b) of the 1939 Code; and said agreement was executed within three years from May 5, 1951, the date the petitioner filed its tax return for the year.

35. The estimated wet gas reserves of the Result property as of September 1, 1944, and the production of wet gas from the property through January 31, 1950 (both expressed in units of one thousand cubic feet of wet gas, the symbol for which is m.c.f.) are as follows:

	<hr/> M.c.f. of Wet Gas <hr/>		
	64 Zone	Tremlor Zone	Total
Estimated Reserve, 9/1/44			5,944,610
<hr/>			
Deduct: Production			
9/1/44 to 12/31/44	789,315	18,295	807,610
Year: 1945	553,592	6,431	560,023
1946	703,213	-0-	703,213

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1947	1,738,318	1,577	1,739,895
1948	958,895	34,374	993,269
1949	1,141,392	-0-	1,141,392
	<hr/>	<hr/>	<hr/>
	5,884,725	60,677	5,945,402
	<hr/>	<hr/>	<hr/>
At 1/1/50, excess of production over estimated reserves			792
Add: January, 1950 Prod.	80,173	-0-	80,173
	<hr/>	<hr/>	<hr/>
At 1/3/50, excess of production over estimated reserves			80,965
			<hr/>

36. During the period of unit operations under Exhibit 3-C (that is, from February 1 to December 31, 1950, inclusive) a total of 273,813 m.c.f. of wet gas was produced from wells located on the surface area of the Result property, all of which came from the 64 Zone.

37. Any reference in this stipulation to production from the Result property shall mean production from wells located on the surface area of the Result property.

February 1, 1956.

Respectfully submitted,

/s/ HARRISON HARKINS,
Counsel for Petitioner.

/s/ JOHN POTTS BARNES, R.E.M.
Chief Counsel, Internal Revenue Service, Counsel for
Respondent.

Filed at hearing February 1, 1956.

The Tax Court of the United States

Docket No. 54288

BELRIDGE OIL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

(Met pursuant to notice.)

Before: Honorable Stephen E. Rice, Judge.

Appearances:

HARRISON HARKINS and

JOHN B. MILLIKEN,

Appearing for and on Behalf of Petitioner.

RICHARD W. JANES,

Appearing for and on Behalf of the Re-
spondent.

Proceedings

The Clerk: Docket No. 54288, Belridge Oil
Company.OPENING STATEMENT ON BEHALF
OF THE PETITIONER

By Mr. Harkins:

Your Honor, this appeal involves income and excess profits tax deficiency for the calendar year 1950 in the amount of \$43,746.32. The deficiency re-

sults from a disallowance of cost depletion claimed and a limitation on percentage depletion claimed on the petitioner's 1950 return.

The basis for these adjustments is such that if the respondent prevails here on his theory, it will have a continuing effect in subsequent years.

Now, the background of the matter is that the petitioner is the producer of oil and gas, and in 1911, it became the owner of what has been described in the petition as its main property, an acreage of some thirty thousand eight hundred odd acres. In the course of the development of the Main Property, they have produced from some five or more separate zones of oil and gas, and although oil and gas was produced from these various zones, both the petitioner and the respondent in prior years have consistently treated this as one property for depletion purposes, and we are agreed for the purpose of this proceeding that there has been a complete recovery of costs on the Main Property in prior years, and on the return, percentage depletion was claimed [3*] with respect to this Main Property.

In 1944 or 1945, the petitioner purchased the property which is described in the petition as the Result Property, somewhat adjacent to its main property, an 80-acre tract, and oil and gas has been produced from two separate zones underlying the Result Property, but in past years, both the Commissioner and the petitioner have consistently treated

*Page numbering appearing at top of page of original Reporter's Transcript of Record.

the Result Property as a separate property to be depleted as a unit. The depletion for all years since acquisition has been on the basis of cost depletion because that was higher than the percentage depletion, and in the year at issue, cost depletion was claimed on the Result Property.

Now, the so-called 64 Zone, or an oil and gas structure, underlies the petitioner's Main Property and also its Result Property and also the properties owned or operated by five other oil companies in the North Belridge Field. Competitive production from the 64 Zone had proved to be wasteful, and as of February 1st, 1950, the six companies agreed to develop the 64 Zone as a unit under the agency of a designated operator, and the petitioner was designated as the operator and has continued to act as such.

Now, the agreements which the six parties entered into are identified in the stipulation, which is to be filed as Exhibits 3-C, 4-D and 5-E. The main issue in this case involves the proper interpretation of this unit agreement [4] document in the interpretation of the document itself or the effects of the document. The petitioner claims that the agreement simply provides for the co-operative development and operation of the 64 Zone as a unit, and was not a title passing agreement. The respondent claims that either the unit agreement or the substance or the results of the unit agreement is that an exchange of property interest occurred, and that the petitioner made a non-taxable exchange of its 64 Zone property interest for an undivided interest in the unit operation of the 64 Zone, and that by reason of that exchange, the new interest

acquired took a basis—took the adjusted basis of the properties transferred, and it must be treated in the future as a separate property, so we have the situation that prior to the execution of this unit agreement, the petitioner had two depletable properties, its Result Property and its Main Property.

Under the respondent's theory, and the theory on which this deficiency has been proposed, it now has three properties, namely, its interest in the unit operation of the 64 Zone, its Main Property exclusive of the 64 Zone, and its Result Property exclusive of the 64 Zone.

The practical effects of this theory are that the cost depletion claimed on the Result Property from February 1st to December 31st of 1955 has been disallowed. Percentage depletion computed by the Commissioner on this new property [5] which he asserts arose out of the unit has become subject to the 50 per cent limitation—50 per cent of net income limitation, and a portion of the percentage depletion claimed on the return has been disallowed.

The Main Property, the percentage depletion has been computed on that by the Commissioner, and that is not subject to a 50 per cent of net income limitation.

Now, the theory of the Commissioner—the disallowance of cost depletion on the Result Property and the treating the 64 Zone as a separate depletable interest—will result in added deficiencies in other years if the Commissioner's theory is upheld.

Now, if the Court should decide that the unit agreement resulted in an exchange of property in-

terest as the respondent claims, then the deficiency asserted is in order with a matter of adjustment of some one hundred twenty or one hundred thirty dollars. If the Court should decide that the respondent is wrong on this main issue and that there was no exchange of property interest, then there would still remain for a decision a further issue raised by the respondent as to the proper method of computing cost depletion on the Result Property. He disputes the method claimed in the return.

We believe that the facts covered by the stipulation to be submitted will, along with the argument and the brief, enable the Court to dispose of this latter issue if it should arise in the course of the case. We have a stipulation with some seven exhibits that will later be submitted.

The petitioner believes that that covers the case as far as it is concerned and they will not introduce evidence.

OPENING STATEMENT ON BEHALF OF THE RESPONDENT

By Mr. Janes:

At first, respondent would like to put in the record that there was an inadvertent denial to the Answer respecting V (g) of the petition. In the Answer with respect to V (g), respondent had admitted a portion and denied a portion of that paragraph. Respondent would now admit the entire paragraph (g); the portion that had been denied, your Honor, was the last half of the second sentence be-

ginning with, "excepting that respondent denies that oil can be moved up or down structure on petitioner's land."

We now admit that such can be done.

The Court: In other words, you want to knock out the "except" clause in your paragraph V (g)?

Mr. Janes: That is right, sir.

The respondent's position in this case is that as a result of the unitization agreement, a new economic interest was obtained by petitioner. The facts in this case, as respondent sees them, are not materially different from what petitioner stated. I think that possibly an analogy or two might help us to understand the problem here. [7]

The unit agreement took place between five separate tax entities, five separate corporations. Petitioner contributed to that unit agreement, in effect, two separate depletable properties. The first was the large bulk of his properties, the Main Property and the Result Property. The Result Property was about 180 acres, I think, so it is considerably smaller in geographical extent than the Main Property contributed.

The other five participants were property interest owners in this oil field. The reason competitive oil interests get together generally to unitize a field is to promote the economic development of the entire field to the mutual benefit of all participants. Such was done in this case. The underlying petitioners contributed properties, the Main, on the one hand, the Result on the other. About 8,000 feet is the zone known as the 64 Zone or Wagon Wheel Zone. The unit agreement only pertained to that zone.

It is as if a checkerboard—as if a layer cake had a checkerboard laid out on top in six squares, and one owner for this analogy, let us say, owned two of the squares and other owners owned the other four they contributed. Well, what they are talking about in the agreement is not the surface or even the first strata. In this instance, it is the middle layer of the cake, and that is all that was involved in this unit. [8]

Under the law, as respondent views it, such an arrangement generally, and in this particular instance, results in a new depletable property, a merger of all the participants into the new.

Let's take this particular case. The taxpayer owns one checker square and the rights to the middle layer of the cake. We will call that the Main Property. He also owns the second checker square with the rights to the oil production from the middle layer of the cake, the 64 Zone.

At that time, prior to the agreement, the taxpayer owns 100 per cent of what rights in oil under the law of oil ownership he can have to the middle layer. This case will involve the exact definition of oil ownership, of course, but prior to the agreement, he owns 100 per cent of the interest in the oil in the middle layer of the cake. After the agreement he owns no such thing. He doesn't own a single percentage of any oil under either one of the two squares contributed. He owns 71.87 per cent of the oil produced by the oil operator of the entire field. He has given up his 100 per cent right to take and keep oil from wells drilled on the surface of this

property in exchange for 71.87 per cent of what the operator of the entire field produces.

Theoretically, in these kind of agreements, the operator would have the right to go to any one of the participants and tell him, "You can't drill your wells for the [9] good of the field. We don't want you to bleed off the gas. We want to maintain constant pressure down through these zones."

Now, those are the facts as we see them prior to the agreement.

Now, the terms of the agreement, respondent feels, show that the participants and the taxpayer in effect obtained a new economic interest, a new depletable property, a new property, with "property" in quotation marks as that word is used in the field of oil and gas.

Let us turn briefly to the agreement which will be Exhibit—which will be an exhibit in this case, and without, of course, reading the entire agreement, I will point to two or three or four sections therein which show that the respondent is taking the only result, in its opinion, under the agreement. Then we will look briefly at the law involved in order to help the Court at this time understand the purpose of certain factual evidence respondent will wish to get into the record.

Now, with respect to the rights of the parties, on Page 4 of the agreement—you want to remember that this agreement—that that unitization agreement is what we are taking about, and this is a contract, an agreement, an agency, or whatever we wish to

call it, a joint venture. It is a mutual contractual device to contractually guarantee to the participants the rights involved. [10]

Now, on Page 4, with respect to the rights of the various parties, Section 1:

“The rights of participants to develop and operate in and to produce from the 64 Zone oil, gas and associated hydrocarbons, and the oil, gas and associated hydrocarbons in the 64 Zone,” that is the middle layer of our cake—“and produce therefrom, are hereby unitized to the end that the 64 Zone shall be developed and operated as a unit by a single operator for the benefit of participants.”

Further down, Section 2:

“Operations hereunder shall be conducted in accordance with sound and efficient oil field practices for the purpose of properly conserving the natural resources of the 64 Zone and endeavoring to obtain ultimately the maximum economic recovery of Unitized Substances.”

That is the oil available from the 64 Zone.

“The powers of the operator”—well, Page 13:

“The initial participants collectively are the owners on the date of this agreement of the right to develop and operate all lands within the area and to produce Unitized Substances”—oil.

Now, that is all they owned. We don’t own any oil in the ground. That is what they owned at that time. [11]

(Continuing): “And are the initial signatory parties. At the effective time of this agreement, Operator shall take exclusive possession of the op-

erating rights of each participant in and to the 64 Zone and enter into the performance of its duties hereunder; subject, however, to the right of each participant to use and occupy its lands within the area pursuant to Section 3, Article II."

Well, now, "subject to" means other than the 64 Zone. That is, the participants who owned the surface rights or the rights in other layers of the cake could go down and develop those.

"Ownership of Unitized Substances." Well, who owns them?

"Each participant shall own a percentage of Unitized Substances equal to the participating equity of such participant."

Prior to the agreement, under the oil and gas law, the participants do not own any oil and gas at all. All they own is the right to take it, that is all they could transfer. What do they get back from the operator? "Equal to the participating equity of such participant." The taxpayer gets back 71.87 per cent of the whole field. It would matter none whether they produced—whether the operator, or acting under the contract, the agents of the operator produced one cubic [12] foot of gas or one quart of oil. It makes no difference, or if they told them not to produce at all from taxpayer's own wells. The production from all wells is allocated to the participants.

"The participants shall own, as tenants in common, all unit wells and unit facilities, and each participant shall own an undivided interest in the unit

wells and unit facilities equal to the participating equity of such participant.”

Now, after the operator operating under this agreement—how is what is produced disposed of? Article VIII, Sections 1 and 2:

“Each participant shall accept its share of the Unitized Substances currently in kind as provided,

“Each participant shall take in kind its participating equity share of the crude oil.”

That is all he can get, just a percentage of what is produced.

Now, there are restrictions in this agreement with respect to the middle layer of the cake here.

“Any participant shall have the right, at any time, without consulting any other participant, to surrender and quitclaim any interest held by it in and to lands within the area other than the [13] right to drill for, develop and produce Unitized Substances.”

Now, the taxes clause in here is interesting. Section 2, for the tax year 1950—well, it amounts to this: That each participant who has paid less State taxes than the amount apportioned to it shall pay the difference to the operator.

In other words, if one of the individuals gets a better State tax levy than the other, you still pool your group liability for State taxes, and then apportion it back plus or minus, much as settling up a gin rummy game among three people.

Now, let's see about transfers. This is from XI, Section 1:

“Each participant shall retain the right at any

time or from time to time to sell, assign, transfer," and so forth, "dispose of, subject to this agreement, its interests."

That ties them up there.

Now, the duration. This is XII, Section 2:

"This agreement, upon becoming effective as provided," and so forth, "shall continue in full force and effect as long as Unitized Substances, or any of them, can be produced from the 64 Zone in quantities determined by participants to be [14] sufficient to pay to produce."

In other words, as long as it is economically advisable.

"However, that this agreement may be terminated prior to such expiration date by the unanimous consent of all participants."

There are other sections in here, which, of course, will go in on brief, your Honor.

There is one interesting point I would like to bring out respecting this instrument as it particularly affects this taxpayer. It will be remembered that there were six separate oil corporations involved in this agreement. Belridge, in effect, contributed what, prior to the agreement, were properly depletable separate properties. One of the other five contributed two or three separate properties. On Page 36 of the agreement—excuse me—on Page 36 of this exhibit, which includes the agreement and is Exhibit B, it sets out Belridge Oil Company's participating equity, that is, the tract value. Belridge, as we know, under the taxpayer's theory, contributed two separate depletable properties to

this agreement, and the taxpayer still alleges that it still has two separate depletable units remaining all during the tenure of this agreement, yet when Belridge contributed his two separate properties, Belridge was allocated 71.87 per cent of what it contributed. There was no allocation [15] in the agreement between Property One and Property Two of Belridge. Belridge was given 71.87 of what it contributed, one plus two equals 87 per cent, as far as Belridge is concerned. No allocation here.

In effect, it might be stated that Belridge voluntarily merged these two properties prior to the agreement or at some time immediately prior.

In Exhibit B, Pages 37, 38 of the attachments it shows that Union Oil was awarded no interest for one lease; 1.18 per cent for a separate lease; and 0.01 per cent for a third lease. In other words, Union separated its properties for allocation purposes in the agreement, but it may be stated that, nevertheless, respondent would treat Union as having received back one depletable unit.

The idea of a merger or exchange, of course, under the respondent's viewpoint—what took place was a like for like exchange, our old friend 112-B-1, not taxable, and I may briefly touch on the facts behind the agreement involved here.

I think we should realize that under respondent's view, the issues here should be divided within the framework of the oil and gas property rights, and that to ultimately decide, in respondent's view, from analogies too strongly drawn from three dimensional law concepts, I think leads us into an eco-

conomic error for the reason that depletion, like depreciation, follows income. [16]

Now, the income received by taxpayer in this year with respect to the unit agreement came from all properties. The taxpayer received only 71.87 per cent of what the operator produced from the field. The taxpayer cannot show what portion of the oil allocated to it came from the Result Property or from its Main Property. It was allocated 71.87 per cent from the entire field. In effect, taxpayer, by carving out Result as a separate depletable property, and making an arbitrary or an estimate allocation to it for cost depletion purposes, ignores the fact basically that it was receiving income from wells drilled on the surface of strangers, other participants in the unit.

I would like to state that I believe it is agreed by all hands that this is a novel question in the sense that it is presented to this court now, and to a larger sense, too, that is to say, there are no judicial opinions directly in point, and actually no I.T.'s directly on it, as such. We have to return to the practicalities, the economic purposes of the peculiar concepts of oil and gas property ownership—ownership, rather. They only own the right to take and keep oil when and if they produce it. There are one or two authorities on the subject which are directly in accord with respondent's position here. I will just touch upon them briefly.

This is Page 6, *Oil and Gas Tax Quartely*, Volume III, Number 1, October, 1953. [17]

Mr. Harkins: Your Honor, I believe this is

getting much beyond the province of an opening statement. I haven't interrupted to date because I just feel that the Court appreciates that this agreement will have to be interpreted and decided on its terms rather than a shotgun reading from its contents and admission of other contents, but when you begin to get into authorities, which are, after all, just editorial comments, I feel sure it is getting beyond the province of an opening statement and is something that should be covered by brief.

Mr. Janes: I am about to conclude, your Honor.

The Court: All right. Go ahead.

Mr. Janes: I would like to add, however, that I did not wish to make an unfair reading of excerpts from the agreement; that I did not wish to read the entire agreement, but those portions which we felt illustrative of the position taken by respondent. I will not go further into the law at this stage. Thank you, sir.

The Court: Does that complete the case?

Mr. Harkins: Yes, your Honor. I wish to reiterate that I am not answering counsel's statement because I feel that that is something that should be handled on brief and will be handled on brief.

The Court: Well, the whole document will be in evidence, will it not? [18]

Mr. Harkins: Yes. It will be in evidence as part of the stipulation.

The Court: I don't believe you need to feel unduly worried about counsel's opening statement.

I would like seriatim briefs in this case, gentlemen.

Mr. Harkins: Your Honor, I misled you. I believe counsel for the respondent is going to call a witness.

The Court: Make your appearances for the record. I believe you forgot to give them.

Mr. Harkins: Harrison Harkins and John B. Milliken for petitioner.

Mr. Janes: Richard W. Janes for respondent.

Mr. Harkins: I would like at this time to offer the stipulation of facts together with the seven exhibits which are referred to and are to accompany that.

The Court: Very well. It will be received.

The Clerk: That will be Joint Exhibit 1-A through 7-G.

(The documents above referred to were received in evidence and marked Joint Exhibits Nos. 1-A through 7-G.)

Mr. Janes: If we may withdraw the 30-day letter for photostating?

The Court: Permission granted. [19]

Mr. Harkins: The petitioner rests, your Honor.

Mr. Janes: If the Court please, may respondent ask the indulgence of the Court for five minutes? I think by consulting a revenue agent, we may well shorten what might be an hour down to ten minutes.

The Court: Certainly. We will have a brief recess.

(Short recess taken.)

Mr. Janes: We will call Roger White.

Whereupon,

ROGER F. WHITE

called as a witness for and on behalf of the Respondent, having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Janes:

Q. What is your name?

A. Roger F. White.

Q. What is your occupation?

A. I am a revenue agent, engineer revenue agent.

Q. Engineer revenue agent in what particular branch?

A. Particularly in natural resource cases, oil and gas and other natural resources.

Q. How long have you been associated with the oil and gas natural resource field?

A. Well, ever since—well, I was graduated from the [20] Colorado School of Mines. I followed the mining and the oil profession ever since I graduated from college.

Q. For quite a few years. We won't pin you down to the exact number.

And you have been employed as engineer revenue agent with the Bureau for a number of years?

A. In Los Angeles since 1939.

Q. You were in the courtroom, I take it, during the opening statements of counsel involving the unitization agreement which the taxpayer joined?

A. Yes, sir.

(Testimony of Roger F. White.)

Q. Did you have occasion prior to today to have any knowledge with respect to the particular oil field involved in this case? A. Yes.

Q. Did you have occasion in the course of your duties, and in your expert knowledge, to examine the unitization agreement and attendant exhibits?

A. Yes.

Q. I show you Joint Exhibit 6-F, Mr. White, which apparently is a geological contour map, and will you please tell us first: What is the area and to what does it pertain? What is it about, in other words?

A. Well, it is a structural contour map showing the underlying structure on the 64 Zone or 64 Sand. In other [21] words, it indicates an anticline and the faulting and other structural features pertaining to the 64 Zone in the North Belridge Field. It also shows the properties of the various leases and owners and the location of the wells.

Q. During the opening statement, Mr. White, respondent stated that the 64 Zone involved is analogous to a middle layer, let us say, of a cake. This map, I take it, then, is a contour map of the middle layer of the cake known as the 64 Zone?

A. It is a contour map on the top of the 64 Zone.

Q. Now, you say the top of the zone. The zone has a thickness, does it not? A. Yes.

Q. Now, I believe most of us are somewhat familiar with the contour map on the surface of the earth. This is comparable, is it not?

(Testimony of Roger F. White.)

A. This is comparable to that, except that its contour is on the horizon underneath the earth.

Q. Yes, but if the top of the 64 Zone were on the surface of the earth, these contour lines would show the varying degrees of altitude of hills, or——

A. No. The structural attitude of the rocks is something in the nature of an elongated dome. These contours indicate that it is an elongated dome, that is, the attitude of the horizon of the 64 Zone, whether it was on the surface [22] or 7,000 feet below the surface, it remains the same. The contour map—if this was on the surface—as quite often you do have structural exposures on the surface—you would still have this kind of a contour map regardless of the surface erosional features which would make the surface contours entirely different.

Q. Now, this map is in what field?

A. It is in the North Belridge Field.

Q. And it shows the 64 Zone. Now, what was that about a dome? In other words—strike that.

I will begin backwards. What is a gas cap in petroleum geology parlance?

A. Well, a gas cap is the accumulation of gas on the structure. Usually the gas separates out on top following the natural laws of physics. In this case, the gas is presumed to be in the top part of the structure.

Q. Do you know, with your familiarity with this field, and the general outlines from this map, which contour lines delineates the gas cap?

A. I have read in some of the material fur-

(Testimony of Roger F. White.)

nished the court that it is roughly the edge of the gas—the lower edge of the gas is roughly at the 7,500-foot contour. Now, that is a generalization, of course. You can't see 8,000 feet in the ground. I assume that is where it is.

Q. Well, on the basis of known geological [23] techniques, and your familiarity with the exhibits in this case and with this field, in particular, you would say that the outer delineation of the gas cap is a 7,500-foot contour?

A. I have no knowledge of the exact position of that gas cap. I mean no—I have never seen any evidence of it, no.

Q. From the pertinent material that you have seen, you would assume that that is where it is?

A. I would assume that is it.

Q. Would you draw a pencil line on this exhibit or make little x marks on this exhibit three or four inches apart around the 7,500-foot delineation contour?

A. Well, the 7,500-foot contour is marked here all along here.

Mr. Harkins: Your Honor, we stipulate the perimeter of the gas cap in the stipulation. It is not—I mean I have no objection to this procedure, but it is not at the 7,500-foot contour. It is within the 7,500 contour. I don't know the purpose of these markings.

Mr. Janes: Well, the word "within" is in the stipulation.

Mr. Harkins: Yes.

(Testimony of Roger F. White.)

Mr. Janes: And I was going to get Mr. White to show on the exhibit what is meant by "within." [24]

Q. (By Mr. Janes): When we say within the contour lies the gas cap, where is it?

A. Everything above the 7,500-foot zone would be—that part of the zone above the 7,500-foot contour would be occupied by gas. It would be the gas zone. In other words, everything above the 7,500-foot contour, everything from here to the top of the structure and from here to the top of the structure. (Indicating.)

Q. Now, on this exhibit, you see, Mr. White, we have a lot of circles with numbers around them and 7,500. A. Well, this is marked——

Q. When you say "within," you mean from 75 to 74 to 73 to 72 to 71, is that it?

A. That's right.

Q. So all the contour lines running downward numerically from 7,500 include the gas cap?

A. Well, that is really running upward, because these are the depths below a fixed base, either sea level or a fixed basis, so this is the highest part of the structure here. Everything from the top down to the 7,500-foot zone presumably would be the gas cap.

Mr. Janes: Counsel, on this exhibit are four red check marks around a rectangle called Belridge Result. I take it we may stipulate those marks show the surface dimensions of the Result Property? [25]

Mr. Harkins: We have that in the stipulation.

Mr. Janes: That is in there?

(Testimony of Roger F. White.)

Mr. Harkins: Yes.

Mr. Janes: Thank you.

Q. (By Mr. Janes): These rectangular lines indicate what on the map?

A. Parcels of land and the land grid, the side lines, section lines, property lines.

Q. They are sections broken up into parcels?

A. Yes.

Q. And the ownership is stated in the center of each parcel? A. Yes.

Q. You are aware that this lawsuit involves the petitioner, Belridge Oil Company?

A. That's right.

Q. Would you please mark on this exhibit by shading in the corners of the parcels owned by Belridge where they overlie the gas cap on this exhibit?

Mr. Harkins: Your Honor, our stipulation reads that as of February 1st, 1950, the perimeter of the gas cap was within the 7,500-foot contour. If counsel wants the exhibit to be marked, and if Mr. White is going to proceed on the basis of within the 7,500-foot contour, then I would like the record to show that that is the situation as of [26] February 1st, 1950.

Mr. Janes: Yes. I just wish to have the rectangles marked out overlying the contour lines, counsel.

The Court: All right. Go ahead.

The Witness: Would you read that question again?

Q. (By Mr. Janes): Would you please mark

(Testimony of Roger F. White.)

out on this map where parcels of land owned by Belridge as of the date of the unitization agreement——

The Court: Is that February 1?

Mr. Janes: February 1, yes, sir, 1950.

Q. (By Mr. Janes): ——overlie the geological contour markings? Now, we already have Belridge marked out. We could shade that in.

A. This is a big job.

(Witness does as requested.)

The Court: Now, what do those markings mean that you have just put on the map?

The Witness: Well, that designates the 7,500-foot contour on the Belridge properties. That is what he asked for. He didn't ask for it on the other properties. He wanted the portion of the gas cap on the Belridge property.

Q. (By Mr. Janes): Then as shown on this map and your markings, does [27] it show that——

Mr. Harkins: Just a moment. You asked him to shade in the contours of all Belridge property within that gas cap. Now, I observe the witness——

The Court: That is what I understood the question to be.

Mr. Harkins: The witness has drawn a line approximately showing the perimeter of the cap, but there hasn't been any shading in. Now, that is going to be quite an extensive operation because—if you want to go off the record——

The Court: No. Go ahead.

(Testimony of Roger F. White.)

Mr. Harkins: That is going to be quite an extensive operation because the Belridge properties are—the Main Property is considerably in the gas cap, the Tide Water is in and a few of the others, but you are going to have to shade in all up in here unless that can be understood that it is apparent from the record that where there is an indication of the word Belridge here without any parentheses, that indicates Belridge property. Where the word is “Belridge Result,” that is also a Belridge property. The other properties of Richfield, Tide Water, Standard, Union and Texaco are also indicated by name.

Mr. Janes: I see. Thank you, counsel. [28]

Q. (By Mr. Janes): From this exhibit, does it appear that a large portion of the Belridge Result Property lies over the gas cap?

A. A part of the Result Property is included in the gas cap, yes.

Q. Did you ever do private consultation work for oil producers? A. Yes, for many years.

Q. In the course of your experience, were you asked at any time the value of a potential purchase by clients? A. Yes, many times.

Q. I will ask you, Mr. White, if it is not one of the main factors in determining the value of an oil property—is it not a fact that one of the main factors of value is the estimated oil reserve?

A. By one method of appraisal, yes.

Q. It is stipulated in this case, Mr. White, that as of September 1st, 1944, the Result Property had

(Testimony of Roger F. White.)

a total oil reserve of 389,596 barrels of oil. On that date the Result came into the ownership and control of taxpayer.

You have shown that Result Property, by the exhibit that you recently marked, overlays the gas cap to a considerable extent, is that not right?

A. That is right.

Q. It is stipulated, Mr. White, that on September 1st—on or about September 1st, 1944, taxpayer bought Result on a [29] time payment or production situation, and obligated itself, taxpayer, to pay for the property the cash value of 820,107 barrels of oil.

Now, speaking as an expert, and as a consultant for potential purchasers of oil property, if those are all the facts that you have concerning the value of the potential purchase, is it not fair to state, in your opinion, that unless that property had another factor of value in the—strike that.

With those facts, and assuming such a price was paid, would you not be of the opinion that the purchaser purchased the Result Property for a purpose other than the extraction of oil reserves thereunder?

Mr. Harkins: Your Honor, that is far beyond the province of the witness to answer. It would be calling for an opinion, not on value, but on the purpose behind the petitioner in making this—if that is intended as a hypothetical question to bring forward an opinion on value, it does not encompass material facts that have been stipulated, and I object to the question if it calls for a general conclusion of what the purpose of this petitioner was. I object

(Testimony of Roger F. White.)

to it if it is intended as a hypothetical question for extracting a value of the Result Property.

The Court: I am frank to admit I don't understand the question. Can you rephrase it? [30]

Mr. Janes: Yes, sir.

The Court: And then you can object again. Let me see if I can understand it, first. I can't rule on your objection until I do.

Mr. Janes: I could take little bits out of it, your Honor. Maybe that will do it better.

Q. (By Mr. Janes): You have shown that the Result Property overlies the gas cap to a large extent. Does that fact alone—and knowing that taxpayer owns considerable other portions of the field—does that fact alone give Result a value other than estimated reserves of oil? A. Certainly, yes.

Q. Why?

A. Well, because the gas—it has value if it is produced.

Q. Situated on the gas cap, what could a non-cooperating owner do to the detriment of other well owners on this field?

A. Well, he could bleed off the gas, of course. That is obvious.

Q. He could bleed off the gas. By that, what do you mean?

A. He could deplete the gas and destroy the natural physical propulsive power of the gas which might affect detrimentally the total ultimate future recovery of oil from [31] the property.

Q. When gas is bled off, as you stated, what hap-

(Testimony of Roger F. White.)

pens within the formation of the structure to either water or oil?

A. Well, you might have a shifting or a movement of the oil and/or the water. You might encourage infiltration of water. You might destroy some of the value in the field or in the property by reducing the probable or possible ultimate recovery of oil.

Q. As the gas is bled off then—looking at this field, this zone, the 64 Zone, as the gas might be bled off unrestrictedly through Result wells, that lessens the pressure in that zone causing the oil and water to move up structure, does it? A. Yes.

Q. And it could very well be detrimental to well owners by having oil which might momentarily be under their wells move away from them?

A. That is right. It might affect the migration of oil.

Q. It might affect the migration of oil?

A. That is right.

Mr. Janes: That is all.

Mr. Harkins: May I have a short recess? I don't believe I have any cross-examination, but I would like to consult with the engineer.

The Court: All right. I will just stay here. [32]
We will have an informal recess.

(Short recess taken.)

Mr. Harkins: No cross-examination.

The Court: You may step down, Mr. White.
Thank you.

(Witness excused.)

The Court: Does that conclude the case, gentlemen?

Mr. Janes: Yes.

Mr. Harkins: Yes.

The Court: Well, I would like seriatim briefs. How much time do you want for your original brief, Mr. Harkins?

Mr. Harkins: Could I have 60 days, your Honor?

The Court: All right. Sixty days for the original brief. Is 45 sufficient for you?

Mr. Janes: Yes.

The Court: Forty-five for yours in reply and 30 for your reply.

Mr. Harkins: Yes.

The Court: All right. We will stand in recess until 7:00 o'clock tonight.

(Whereupon, at 11:30 o'clock a.m., Wednesday, February 1, 1956, the hearing in the above-entitled matter was closed.)

Filed February 17, 1956, T.C.U.S. [33]

[Title of Tax Court and Cause.]

FINDINGS OF FACT AND OPINION

Filed March 29, 1957

Prior to February 1, 1950, petitioner and five other oil companies owned separate producing rights to an oil pool in Kern County, California, known as the 64 Zone. Prior to that date, the companies had engaged in unrestricted competitive production

of oil from the Zone. Petitioner owned two separate properties which overlay the Zone. On one, the Main Property, it had taken percentage depletion because it had already recovered its cost basis. It had taken cost depletion on the other, the Result Property, since that was higher than percentage depletion. Unrestricted competitive production had lowered the gas pressure in the Zone, and on February 1, 1950, the petitioner and the five other oil companies effected a unitization of their property interests in the Zone by an agreement under which each company was to receive a percentage share of total production from the Zone, which production was to be carried on by one company in behalf of all the participants to the agreement. Under the agreement, each participant retained the full right to sell, assign, or otherwise dispose of any of its property interests covered by the agreement, subject only to the production limitations imposed thereby. In computing its allowable depletion for 1950, petitioner allocated its share of unitized production to its Main and Result Properties, claiming percentage depletion on the former and cost depletion on the latter, as it had done in previous years. Respondent determined that the effect of the unitization agreement was a tax free exchange under section 112 (b) (1) by petitioner of its operating rights in its two separate properties covered by the agreement for a new depletable interest consisting of its share in unitized oil production, which determination had the effect of eliminating any cost depletion for the Result Property after unitization and thus reduced the

total amount of depletion claimed by petitioner on its share of unitized production. Held, petitioner did not exchange its interests in its two separate properties for a new depletable interest by participating in the unitization agreement, and it is entitled to claim percentage depletion on that part of unitized oil production attributable to its Main Property, and cost depletion on that part attributable to its Result Property. Held, further, the amount of unitized oil allocable to the two properties determined.

JOHN B. MILLIKEN, ESQ., and
HARRISON HARKINS, ESQ.,

For the Petitioner.

RICHARD W. JANES, ESQ.,

For the Respondent.

This proceeding involves a deficiency in income tax in the amount of \$33,879.44 and a deficiency in excess profits tax in the amount of \$9,866.88 for the year 1950. Petitioner claims an overpayment of taxes for such year.

The issues to be decided are: (1) Whether, by joining in a unitization agreement for the co-operative operation of all wells in a certain oil pool, petitioner exchanged its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under unitized operation; and (2) if not, the amount of the cost depletion allowance

which it is entitled to deduct for one of its separate properties covered by the unitization agreement.

Some of the facts were stipulated.

Findings of Fact

The stipulated facts are so found and are incorporated herein by this reference.

Petitioner, a California corporation, filed its return for 1950 with the former collector of internal revenue at Los Angeles, California.

For many years petitioner has been engaged in the business of producing oil and gas from lands located in Kern County, California. In 1911, it acquired ownership in fee of some 30,845.96 acres, hereinafter referred to as the "Main Property." Two separate production fields, known as the North and South Belridge fields, were developed on that property. On September 1, 1944, petitioner purchased both the working interest and the landowners' and royalty owners' rights in a producing property known as the Result Property, consisting of 80 acres adjacent to the North Belridge field.

Oil and gas production from the North Belridge field is obtained from five different zones located at various depths. These are the Shallow Zone, which produces from relatively shallow depths; the Temblor Zone, whose approximate depth is 6,000 feet; the R. Zone, with an approximate depth of 7,000 feet; the 64 Zone, whose approximate depth is 8,000 feet; and the Y Zone, with an approximate depth

of 9,000 feet. The 64 Zone and the Temblor Zone also underlie portions of petitioner's Result Property.

The depletable interests here in issue are located in the 64 Zone. This zone is the largest developed oil and gas reservoir underlying petitioner's Main and Result Properties. It also underlies portions of adjacent and nearby land owned or operated by five other oil companies. The gas cap of the 64 Zone is located principally under petitioner's land, and oil can be moved up or down structure from petitioner's land by lessening or increasing the gas cap pressure.

Prior to October, 1941, production by petitioner and the five other oil companies operating in the 64 Zone was entirely on a competitive basis. By 1938, total oil production from the Zone reached approximately 12,000 barrels a day. Subsequent to 1938, the reservoir pressure and oil production from the Zone steadily declined. From some time in October, 1941, to April 1, 1947, a voluntary gas pressure maintenance program was put into effect by the companies producing from the Zone, and a portion of the gas produced from the Zone was returned to the reservoir. From April 1, 1947, until February 1, 1950, the six companies producing from the 64 Zone abandoned the program of voluntary pressure maintenance and resumed unrestricted competitive production.

During the period of unrestricted competitive production, April 1, 1947, to January 31, 1950, a

total of 3,255,417 barrels of oil were produced from the 64 Zone area. During the same period, petitioner produced 2,011,897 barrels from the 64 Zone from wells located on its Main Property, and 90,261 barrels from wells located on its Result Property.

On July 1, 1949, but effective as of February 1, 1950, petitioner and the five other oil companies producing from the 64 Zone entered into a unitization agreement which provided for the production of oil and gas from the Zone on a co-operative basis. The unitization agreement provided generally that the development and operation of all of the Participants' 64 Zone properties should be conducted by a designated operator with each Participant receiving an agreed upon percentage of all the oil, gas, and associated hydrocarbons produced.

Pertinent provisions of the agreement, are set forth below:

This Agreement * * * between the undersigned parties, each of whom is hereinafter called "Participant,"

Witnesseth:

* * *

Article I.

Definitions

Section 1. The following definitions shall apply to the following terms as employed in this agreement:

* * *

(c) Unitized Substances shall mean all oil, gas and associated hydrocarbons produced and saved from the 64 Zone pursuant to this agreement.

* * *

(e) Participant shall mean an owner at the date of this agreement, and each successor, assignee or transferee of such owner, of the right to develop and operate lands within the Area and to produce Unitized Substances, whether as lessee or otherwise, and shall include the owner of such lands not under lease as well as the lessee of such lands under lease.

* * *

(g) Tract Value shall mean that percentage which is the share of the Unitized Substances allocated under this agreement to each respective tract of land within the Area.

* * *

Article II.

Unitization-Conservation

Section 1. The rights of Participants to develop and operate in and to produce from the 64 Zone oil, gas and associated hydrocarbons, and the oil, gas and associated hydrocarbons in the 64 Zone and produced therefrom, are hereby unitized, to the end that the 64 Zone shall be developed and operated as a unit by a single operator for the benefit of Participants. The Tract Values set forth in the table attached hereto marked Exhibit "B" are hereby allocated to the respective tracts of land shown

therein. The Participating Equities set forth in the table attached hereto marked Exhibit "C" are hereby allocated to the respective Participants. The aggregate Tract Values of the lands of each Participant shall be equal, at all times, to the Participating Equity of such Participant. * * *

* * *

Section 3. * * * this agreement shall not apply to interests, rights or obligations in any formation, zone or stratum other than the 64 Zone. Each Participant reserves whatever rights it may have to develop and produce oil, gas and associated hydrocarbons from any and all formations, zones or strata other than the 64 Zone * * *.

* * *

Article V.

Transfers of Operating Rights and Other Property

Section 1. The initial Participants collectively are the owners on the date of this agreement of the right to develop and operate all lands within the Area and to produce Unitized Substances, and are the initial signatory parties to this agreement (exclusive of any exhibit hereto). At the effective time of this agreement Operator shall take exclusive possession of the operating rights of each Participant in and to the 64 Zone and enter into the performance of its duties hereunder; * * *.

* * *

Section 7. * * * Each Participant represents and warrants that as of the effective time of this agreement such Participant owns the unencumbered right to develop and operate the lands within the Area as to which it is a Participant and to produce Unitized Substances therefrom * * *.

* * *

Article VII.

Ownership of Unitized Substances, Unit Wells and Unit Facilities; Participation; Payment of Costs and Expenses

Section 1. Each Participant shall own the percentage of Unitized Substances equal to the Participating Equity of such Participant.

Section 2. The Participants shall own, as tenants in common, all Unit Wells and Unit Facilities, and each Participant shall own an undivided interest in the Unit Wells and Unit Facilities equal to the Participating Equity of such Participant.

Section 3. In the event of changes in Participating Equities pursuant to Article XI, the ownership of each Participant in Unitized Substances, Unit Wells and Unit Facilities shall change correspondingly.

Section 4. * * * If any numbered tract of land set forth in Exhibit "B" is now or hereafter becomes divided in ownership of Unitized Substances or Royalty Interest, or both, then, in the absence of an agreement between the interested parties deter-

mining the Tract Values of each segregated portion of such tract of land, the Tract Value shall be distributed to the segregated portions of such tract of land on a surface acreage basis, or if less than an entire numbered tract of land set forth in Exhibit "B" is excluded from this agreement as provided in Section 3 of Article XI, the Tract Value to be assigned to the portion of such tract of land remaining subject to this agreement shall be determined on a surface acreage basis.

* * *

Article VIII.

Disposition of Unitized Substances

Section 1. Each Participant shall accept its share of the Unitized Substances (other than gas or other Unitized Substances used for injection or in operations hereunder) currently in kind * * *.

* * *

Article X.

Payment of Rentals, Royalties and Taxes

Section 1. Each Participant shall pay all rentals, royalties, overriding royalties and other payments which pertain to or affect lands of such Participant subject to this agreement, including the 64 Zone, and which may be or become payable pursuant to any lease, operating agreement or other instrument to which such Participant is a party by privity of contract or privity of estate, and each Participant

shall promptly furnish to Operator, upon demand, a statement that payment thereof has been made. * * *

* * *

Article XI.

Assignments and Transfers; Rearrangement or Revision of Tract Values and Participating Equities

Section 1. Each Participant shall retain the right at any time or from time to time to sell, assign, transfer, quitclaim, surrender or otherwise dispose of, subject to this agreement, its interests, or any thereof, in whole or in part, in or to the lands or any thereof of such Participant in the Area and in or to the Unit Wells and Unit Facilities, provided that no interest in lands with respect to the 64 Zone shall be transferred or surrendered separate from a corresponding interest in Unit Wells and Unit Facilities, or vice versa. If an interest in lands with respect to the 64 Zone shall be transferred or surrendered, the transferee or person receiving such surrender shall be and become one of the Participants under this agreement, * * *.

Section 2. * * * If any numbered tract of land set forth in Exhibit "B" is divided, then, in the absence of an agreement between the interested parties determining the Tract Values of each segregated portion of such tract of land, the Tract Value shall be distributed to the segregated portions of such tract of land on a surface acreage basis.

* * *

Article XII.

Effective Time and Duration

Section 1. This agreement shall become effective at 7:00 o'clock a.m. on the first day of the first calendar month which commences not less than ten (10) days after all the following events shall have occurred:

(a) Execution of this agreement by all Participants listed in Exhibit "C."

(b) Execution of Lessors' and Royalty Owners' Consent, substantially in the form annexed hereto marked Exhibit "E," by at least ninety per cent (90%) in interest of the owners of Royalty Interests under each tract of land with respect to which a Participant has executed this agreement, unless all Participants shall otherwise agree in writing.

(c) Approval of this agreement by the Oil and Gas Supervisor of the State of California, pursuant to the provisions of Section 3301 of the Public Resources Code of the State of California, on the form of "Approval and Determination" annexed hereto marked Exhibit "F."

Section 2. This agreement * * * shall continue in full force and effect as long as Unitized Substances, or any of them, can be produced from the 64 Zone in quantities determined by Participants to be sufficient to pay to produce; provided, however, that this

agreement may be terminated prior to such expiration date by the unanimous consent of all Participants.

* * *

Article XIII.

Miscellaneous

* * *

Section 3. It is the intention of each Participant to establish Operator as its agent under this agreement, for the sole purpose of developing, operating and protecting its interest in the 64 Zone to the extent herein set forth.

The Participants in the unitization agreement and their respective "Participating Equities" were as follows:

Participant	Participating Equity and Tract Value Assigned
Belridge Oil Company.....	71.87%
Tide Water Associated Oil Company.....	16.58%
Richfield Oil Corporation.....	4.44%
The Texas Company.....	4.44%
Standard Oil Company of California.....	1.48%
Union Oil Company of California.....	1.19%

The tracts of Belridge, Tide Water, Richfield, Standard, and one of the three tracts of Union were held in fee by such companies. The tracts of the Texas Company and two of the three tracts of the Union Oil Company were leaseholds. The participating equities allotted to the parties approximated

the percentages of the total production from the 64 Zone which each of the respective parties had obtained during the period of unrestricted competitive production which immediately preceded the effective date of the agreement.

The agreement further provided that each Participant was obligated to pay a part, equal to its participating equity, of all costs and expenses of the unit operation.

Petitioner was designated as the original Operator and has continued to act as such. The agreement provided that all matters relating to the removal of the Operator and the selection of a successor Operator should be determined by the agreement of not less than three Participants representing, in the aggregate, not less than 80 per cent of the participating equities.

On January 17, 1950, the Participants agreed, as provided in Article XII, Section 1 (b), that the unitization agreement would become effective at 7:00 a.m., February 1, 1950, despite the fact those holding lessors' and royalty owners' interests in 90 per cent of the land covered by the agreement had not executed consents to the agreement.

A number of the lessors and royalty owners who possessed interests in the 64 Zone covered by the leases held by The Texas Company and the Union Oil Company executed consents to the agreement, and those companies endorsed their acceptance of such consents.

Petitioner, Tide Water, Richfield, and Standard, all of whom were Participants under the agreement, and who together owned in fee, 92 per cent of the land covered by the agreements, did not execute lessors' and royalty owners' consents.

The portions of petitioner's two properties affected by the unitization agreement were the 64 Zone underlying its Result Property and the 64 Zone underlying some, but not all, of its Main Property. It did not affect any of the other zones underlying petitioner's land. Petitioner and the other five Participants continued to operate and produce from one or more of the other zones underlying the same surface area of their respective properties as were covered by the agreement. Petitioner took no production from the Temblor Zone of its Result Property during the years 1949 to 1953, inclusive, but in 1954, it resumed production from the Temblor Zone.

Under unitized operation in 1950 (February 1 through December 31), a total of 428,139 barrels of oil were produced from the 64 Zone—21,672 barrels from wells located on petitioner's Result Property, 215,390 barrels from wells located on its Main Property, and 191,077 barrels from wells located on the properties of other Participants. Petitioner's 71.87 per cent share of total production was 307,704 barrels.

Prior to 1950, petitioner had completely recovered its tax basis for its Main Property through cost depletion allowances, and therefore computed its

allowable depletion deduction on the statutory percentage of income. For its Result Property, depletion based on adjusted cost has consistently been greater than depletion based on the statutory percentage of income.

On its return for 1950, petitioner claimed cost depletion on its Result Property and percentage depletion on its Main Property, as it had done in previous years. It computed cost depletion on the Result Property for the month of January on the basis of the actual number of barrels of oil taken from wells located on that property during such month. To arrive at the number of barrels of oil which it claimed were attributable to its Result Property from its share of total unitized oil produced during the remainder of the year, it determined the ratio of production from the 64 Zone of that property in 1949 to its total 64 Zone production during that year and applied that ratio to the total 64 Zone production allotted to it under unitized operation for 1950. The remainder of the oil received from unitized production was added to its individual production from its Main Property and percentage depletion was claimed on the total. Petitioner thus claimed cost depletion on the Result Property in the amount of \$72,010.63, and percentage depletion on its Main Property of \$1,568,662.93.

On its return for 1950, petitioner reported the adjusted cost of Result, as of January 1, 1950, to be \$689,863.29, and used a cost basis of \$3.43035 a

barrel in computing cost depletion. Petitioner claimed an increased cost in its petition, and the parties agree that the cost basis was \$1,007,976.81 on January 1, 1950, and that such basis increased by an additional \$8,886.29 prior to the end of the year. They also agree that the remaining oil reserves of the property were as follows:

Remaining Reserve on	Barrels of Oil		Total
	64 Zone	Tremblor Zone	
January 1, 1950	177,308	23,798	201,106
January 31, 1950	173,978	23,798	197,776

Respondent determined that, by virtue of the unitization agreement, petitioner made nontaxable exchanges on February 1, 1950, of its two separate interests in the 64 Zone for a single depletable interest therein, consisting of its 71.87 per cent undivided interest in the properties covered by the agreement. He determined that petitioner's basis for such undivided interest was the combined adjusted bases of its separate interests in the 64 Zone, and that the statutory percentage depletion allowable thereon would give it the maximum depletion allowance. He disallowed \$56,888.79 of the depletion deduction claimed by petitioner on its return, as follows: Petitioner's computation of percentage depletion on its Main Property was revised by excluding from the Main Property, for the period February 1, 1950, to December 31, 1950, the production from the 64 Zone unitized area of the property; cost depletion on the Result Property for the month of January, 1950, was computed and allowed on a cost basis of \$1,007,976.81; since no pro-

duction was obtained from the other producing zone of Result during 1950, no additional cost depletion was allowed for that property for the period February 1 to December 31, 1950; percentage depletion in the amount of \$278,668.82 was allowed for petitioner's 71.87 per cent undivided interest in the unitized properties. No computation of cost depletion with respect to that 71.87 per cent undivided interest appears in the deficiency notice.

The petitioner, aside from the claim of overpayment made in its petition, did not file a refund claim for the year in issue; and no part of the income and excess-profits taxes of \$1,019,485.40, paid by it for such year, has been refunded or otherwise credited to it.

Petitioner paid a \$203,897.08 installment of its 1950 taxes on December 7, 1951, which amount was paid within two years before the November 2, 1953, execution by the petitioner and the respondent of the extension agreement pursuant to section 276 (b) of the 1939 Code; and such agreement was executed within three years from May 5, 1951, the date the petitioner filed its tax return for 1950.

Opinion

Rice, Judge:

The consolidation of oil producing properties under centralized production management, commonly referred to as unitization, is a conservation program to effect the most economical and productive extraction of oil, gas, and associated hydrocar-

bon products from a given oil or gas field. Unitization may be effected by voluntary agreement of the separate owners of oil and gas properties and interests, or, in some states, by compulsory action of duly authorized state authority.

When voluntary unitization is effected, it may be done by means of a community lease in which several land owners, each owning separate tracts of land, join in a single oil or gas lease describing and granting, for development purposes, the entire area owned by them to a single developer. It may also be effected by the lessees of oil development rights whose leases give them the express consent of the lessors to develop the leased property under unitized operation: or, unitization may be effected by a separate unitization agreement among oil producers such as the one before us here. The participants in the unitization agreement here were fee holders or lessees, each of whom, however, had the exclusive right to develop the 64 Zone oil pool beneath its respective surface area of land.

Prior to the effective date of the agreement, petitioner held two separately depletable oil producing properties. On one, the Main Property, it had completely recovered its tax base and was claiming percentage depletion. On the other, the Result Property, it was claiming cost depletion. After unitization, it claims that it is still entitled to claim percentage depletion on that part of its share of unitized oil attributable to its Main Property, and cost depletion on that part of its share of unitized oil attributable to the Result Property.

By claiming both cost and percentage depletion on the respective shares of unitized oil which it attributes to the two properties, petitioner arrives at a greater depletion deduction than the respondent's determination would allow, since he permitted only the statutory percentage depletion on all of petitioner's share of unitized oil. No issue is raised as to petitioner's having a depletable economic interest in unitized oil production, but only as to the method it used in computing depletion on such production.

The respondent contends that the effect of the unitization agreement here was a tax free exchange by petitioner of its oil producing rights in the 64 Zone pool underlying its Result Property, and that part of its Main Property subject to the agreement, for a new and separate depletable economic interest consisting of and measured by its 71.87 per cent share of oil produced under unitized operation of the field. Section 112 (b) (1)¹ provides, in sub-

¹Sec. 112. Recognition of Gain or Loss.

* * *

(b) Exchanges Solely in Kind—

(1) Property held for productive use or investment—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

stance, that no gain or loss shall be recognized if property held for productive use in a taxpayer's trade or business is exchanged solely for property of a like kind to be held for a like purpose. To uphold the respondent's determination, we must find that the unitization agreement here, preferably both in form and in substance, effected an exchange; and, if not in form, certainly in substance.

Our examination of the unitization agreement discloses no words of conveyance. The key provision of the agreement by which unitization was effected is found in Article II, Section 1, as follows:

The rights of Participants to develop and operate in and to produce from the 64 Zone oil * * * are hereby unitized, to the end that the 64 Zone shall be developed and operated as a unit by a single operator for the benefit of Participants.

Article V, Section 1, provided that at the effective date of the agreement, the Operator should take exclusive possession of the operating rights of each Participant and was to enter into the performance of his duties. Article VII, Section 1, provided that each Participant should own the percentage of unitized substances equal to its participating equity, and Article VIII, Section 1, provided that each Participant should accept its share thereof currently in kind. Article XI, Section 1, retained for each Participant the full right to sell, assign, transfer, quitclaim, surrender, or otherwise dispose of its interest in any land covered by the agreement,

subject only to the production limitations imposed thereby. Neither in those provisions of the agreement, nor elsewhere, do we find any words of conveyance; and, more important, we find no intention on the part of the Participants to convey or exchange their economic interests in the 64 Zone. We recognize that the agreement provided that all wells and production equipment used by the Operator were to be held by the Participants as tenants in common. But that joint ownership was only of depreciable equipment and certainly not of the depletable economic interests and rights to drill and produce oil from the land.

We think the net effect of what the Participants to the agreement accomplished was the creation and organization of a consolidated production operation for the extraction of their respective shares of oil from the whole pool in which they held separate operating rights. The purpose which prompted the execution of the agreement in question was the recognition on the part of the Participants that unrestricted competitive production from the Zone was causing a lowering of the gas pressure and would eventually result in possible serious underground waste of oil, gas, and associated hydrocarbon products. For a period of some 5½ years prior to April 1, 1947, the Participants had maintained a voluntary gas pressure program whereby a portion of the gas produced from the Zone was returned to the reservoir. We think the unitization agreement here was nothing more than another joint effort on the

part of the owners of the producing rights to the Zone to best conserve their respective individual interests therein by joining in a plan for the most economical and productive operation of the whole field. Hence, we think each Participant had exactly the same interests and rights in its respective properties after unitization as before, except that by mutual consent they had agreed to limit their production and operate their wells in the most economically feasible way from the standpoint of conservation considerations.

The statute specifically gives a taxpayer, who owns a depletable economic interest in oil, which all concede the petitioner here had, an election to deplete its interest on the basis of the statutory percentage amount provided in section 114 (b) (3), or by recovering its cost basis, whichever is greater. It seems to us that the respondent's determination here would deprive petitioner of the just due given it by the express terms of the statute.

Having concluded that petitioner retained its original separate depletable economic interests in the 64 Zone, we turn now to the question of the exact amount of cost depletion which it is entitled to claim on the Result Property. As noted in our findings of fact, it computed such cost depletion on its return by allocating a portion of its share of the unitized oil production to that property on the basis of the ratio of its production from such property in 1949 to its total 64 Zone production during that year and then added such allocated amount to the

actual production for the month of January, 1950. On brief, petitioner argues that the allocation of a portion of its share of unitized oil production should be made on the basis of the ratio of actual Result production from the 64 Zone during the period of unrestricted competition preceding the effective date of the agreement to the total 64 Zone oil production during such period by all producers.

The respondent insists that even if we uphold the petitioner's position with respect to its having a depletable interest in two separate oil producing properties both before and after unitization, as we have done, no allocation of unitized oil production can be made to the Result Property because of the mechanics involved in the computation of cost depletion. He argues that in computing cost depletion, actual production from the property each year must be subtracted from the estimated reserve at the beginning of the year.² He points out that under unitized operation from February 1 to December 31, 1950, some 21,672 barrels of oil were actually produced from wells located on the Result Property. He argues further that under petitioner's theory of allocation, a lesser number of barrels (11,859) would be allocated to that property, and concludes that under such plan of allocation, the estimated total reserves at the beginning of the period would, in fact, be exhausted long before petitioner's theoretical cost depletion would indicate because the total production from wells on the Result Property,

²Regulations 111, Sec. 29.23(m)-2.

rather than an allocated portion, must be subtracted each year in arriving at the remaining oil reserve.

We do not agree with this argument. It seems to us that the simple answer to the respondent's objection is that oil taken from the 64 Zone through wells located on the Result Property, in excess of the allocation which petitioner contends should be made, must be deemed to be oil from other areas in the pool made possible only by the unitization agreement.

Insofar as petitioner's plan of allocation suggested on brief is concerned, we think it is in substantial accord with the agreement between the Participants. The parties stipulated that each Participant's share in unitized production was based on the production record of the various properties subject to the agreement during the period of unrestricted competitive production prior to the effective date of the agreement. And while the agreement does not allocate a share of total unitized production individually to petitioner's Main and Result Properties, we think that it was clearly the intent of the participants that petitioner's total share was allocated on the basis of its previous production from those two properties. We therefore conclude that the ratio which 90,261 barrels bears to 3,255,417 barrels (total Result 64 Zone production and total 64 Zone production April 1, 1947, to February 1, 1950), or 2.77 per cent, multiplied by the total production from the Zone under unitized operation

during 1950 of 428,139 barrels, or 11,859 barrels, are the proper number of barrels allocable to the Result Property for the period February 1 to December 31, 1950.

Decision will be entered under Rule 50.

Entered March 29, 1957.

Served March 29, 1957.

[Title of Tax Court and Cause.]

COMPUTATION FOR ENTRY OF DECISION

The attached computation reflecting a deficiency in income tax in the amount of \$1,246.97 for the taxable year 1950 is submitted on behalf of the respondent in compliance with the opinion of the Court determining the issues in this proceeding.

The computation is submitted without prejudice to the respondent's right to contest the correctness of the decision entered herein by the Court pursuant to the statute in such cases made and provided.

/s/ NELSON P. ROSE, R.E.M.
Chief Counsel Internal Revenue Service.

Of Counsel:

MELVIN L. SEARS,
Regional Counsel;

E. C. CROUTER,
Assistant Regional Counsel;

R. E. MAIDEN, JR.,
Special Assistant to the
Regional Counsel;

RICHARD W. JANES,
Attorney, Internal Revenue
Service.

Without prejudice to the right of appeal, it is agreed that the attached computation is in accordance with the opinion of the Tax Court in the above-entitled proceeding.

/s/HARRISON HARKINS,
Counsel for Petitioner.

Ap:LA:AA-EWM

Recomputation Statement

July 8, 1957.

In re: Belridge Oil Company
601 West Fifth Street, Room 815
Los Angeles 17, California

Docket No. 54288

Income Tax

Year	Liability	Assessed	Deficiency
1950	\$1,020,732.37	\$1,019,485.40	\$1,246.97

The recomputation of tax liability shown herein is in accordance with the opinion of the Tax Court of the United States filed March 29, 1957, for decision to be entered under Rule 50.

Year 1950

Adjustment to Net Income

	Income Tax Net Income	Excess Profits Net Income
Net income as disclosed by the deficiency notice dated May 28, 1954	\$2,350,549.01	\$2,247,054.97
Additional deduction:		
(a) Depletion	74,399.32	74,399.32
Net income as adjusted	\$2,276,149.69	\$2,172,655.65

Explanation of Adjustment

(a) Net income is decreased \$74,399.32, representing adjustment of deduction for depletion computed as follows:

Depletion allowed in deficiency notice:

Cost depletion allowed on result property for the month of January	\$ 16,690.52	
Percentage depletion allowed	1,567,094.25	\$1,583,784.77

Revised depletion allowance:

Cost depletion allowed on result property as computed in Exhibit B, attached	\$ 76,800.96	
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Percentage depletion allowed on Belridge property for the year, as computed in Exhibit A, attached	1,581,383.13	1,658,184.09
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Additional depletion allowance		\$ 74,399.32
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Computation of Tax
Income Tax

	Tax at Ordinary Rates	Alternative Tax
Income tax net income	\$2,276,149.69	\$2,276,149.69
Less: Net long-term capital gain ..		103,494.04
Surtax net income	\$2,276,149.69	\$2,172,655.65

	Tax at Ordinary Rates	Alternative Tax
Combined normal tax and surtax:		
\$2,276,149.69 at 42% minus		
\$4,750.00	\$ 951,232.87	\$ —
\$2,172,655.65 at 42% minus		
\$4,750.00		\$ 907,765.37
Add: 25% of net long-term capital gain		25,873.51
Tax at ordinary rates	\$ 951,232.87	\$ —
Alternative tax (lesser tax)		\$ 933,638.88
Income tax		\$ 933,638.88

Excess Profits Tax

Excess profits tax net income		\$2,172,655.65
Less: Excess profits credit per deficiency notice		1,596,765.67
Adjusted excess profits net in- come		\$ 575,889.98
(1) 30% of \$ 575,889.98		\$ 172,766.99
(2) 62% of \$2,172,655.65	\$1,347,046.50	
Less: Combined normal tax and surtax on \$2,172,655.65	907,765.37	\$ 439,281.13
Excess profits tax (lesser of (1) or (2)		\$ 172,766.99
Proration of excess profits tax 184/365 of \$172,766.99		\$ 87,093.49
Income tax from above		\$ 933,638.88
Excess profits tax from above		87,093.49
Income tax liability		\$1,020,732.37
Income tax assessed: Original return, Account No. 4180941, Los Angeles District		1,019,485.40
Deficiency in income tax		\$ 1,246.97

lri

	total bridge property	Gas & L.P.G.	Other	Overhead	Total
ross	3,769.62	\$575,638.00			\$6,398,467.33
per					
ans					
Cou					
Res					
Zon					
par	6,714.50				
ross	10,484.12	\$575,638.00			\$6,398,467.33
ther	3,585.40	(179.77)	\$401,960.42	\$ 1,842.12	362,872.53
total	1,897.72	\$575,458.23	\$401,960.42	\$ 1,842.12	\$6,761,339.86
expe					
D	8,560.17	\$205,763.16			
	4,912.53	338,039.58			
	0,740.21	15,313.06			
	2,090.61	106,194.23			
	(116.13)				
ota	6,187.39	\$665,310.03			\$1,938,605.75
ran	0,752.40	(104,791.05)			
repr	9,808.82	107,739.97			505,167.31
ran	4,957.80	(15,557.38)			
mor		4,487.33			4,487.33
ban	8,453.77				18,453.77
			\$ 6,012.08		6,012.08
			3,620.35		8,620.35
			2,350.00		2,350.00
ota	0,160.18	\$657,183.90	\$ 16,982.43		\$2,483,696.59
ver				\$342,768.21	342,768.21
(a)	8,795.13	90,376.93		(312,582.33)	
(b)	8,361.16	11,646.62		(30,185.88)	
	1,289.41	(532.61)		\$ 1,842.12	
ota	6,027.06	\$758,679.84	\$ 16,982.43	\$ 1,842.12	\$2,826,461.80
et	5,870.66	\$(183,221.61)	\$384,977.99	None	\$3,934,875.06
06	2,935.33	\$ (91,610.81)	192,489.00	- -	
73	1,383.13	158,300.45	None		
illo	1,383.13	None	None	- -	

<u>Total Belridge Property</u>	<u>Gas & L.P.G.</u>	<u>Total</u>
\$1,256,187.39 <u>100,752.40</u>	\$665,310.03 <u>(104,791.05)</u>	\$1,938,605.75 <u>-</u>
\$1,356,939.79 69.996%	\$560,518.98 28.913%	\$1,938,605.75 100%
<u>\$ 218,795.13</u>	<u>\$ 90,376.95</u>	<u>\$ 312,582.33</u>
 \$ 239,216.20 <u>32,266.68</u>	 \$205,763.16 <u>(33,560.09)</u>	 \$ 446,319.91 <u>-</u>
\$ 271,482.88 60.827%	\$172,203.07 38.583%	\$ 446,319.91 100%
<u>\$ 18,361.16</u>	<u>\$ 11,646.62</u>	<u>\$ 30,185.88</u>

Belridge Oil Company

EXHIBIT B

Computation of Cost Depletion on Result Property
for the Period January 1, 1950, Through De-
cember 31, 1950

Basis for depletion of Result property at Janu- ary 1, 1950, as shown by the stipulation of facts	\$1,007,976.81
Add: Additional Cost of Result property due to increase in selling price of crude oil dur- ing the period January 1, 1950, through December 31, 1950	8,886.29
	<hr/>
Basis for depletion of Result property at January 1, 1950	\$1,016,863.10
Estimated reserve at January 1, 1950, as per stipulation of facts	201,106 barrels
Cost per barrel	\$ 5.0563538
Production from Result property for the month of January, 1950, as shown by the stipulation of facts	3,330 barrels
Production from Result property for the pe- riod February 1 through December 31, 1950, as per the opinion of the Tax Court of the United States	11,859 barrels
	<hr/>
Total production for the year 1950	15,189 barrels
Allowable Cost depletion on Result property for the period January 1 through December 31, 1950	\$ 76,800.96

Received and filed July 24, 1957, T.C.U.S.

Tax Court of the United States

Docket No. 54288

BELRIDGE OIL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion filed March 29, 1957, the respondent filed a computation for entry of decision on July 24, 1957. The petitioner having acquiesced therein, it is

Ordered and Decided: That there is a deficiency in income tax for the taxable year 1950 in the amount of \$1,246.97.

/s/ J. MURDOCK,
Judge.

Entered July 26, 1957.

Served July 29, 1957.

Entered July 29, 1957.

[Title of Tax Court and Cause.]

T. C. Docket No. 54288

PETITION FOR REVIEW

To the Honorable Judges of the United States
Court of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue petitions the United States Court of Appeals for the Ninth Circuit to review the decision of The Tax Court of the United States, entered in this case on July 26, 1957, pursuant to its opinion filed March 29, 1957 (27 T.C. . . . No. 128), ordering and deciding "That there is a deficiency in income tax for the taxable year 1950 in the amount of \$1,246.97."

This petition for review is taken pursuant to the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954.

Jurisdiction

The respondent on review, Belridge Oil Company, is a California corporation, with offices in Los Angeles, California, and filed its Federal income tax and excess profits tax return for the taxable year 1950, the year involved herein, with the former Collector (now District Director) of Internal Revenue for the Sixth District of California, whose office is located at Los Angeles, California, which collection district is within the jurisdiction of the United States Court of Appeals for the Ninth Circuit, wherein this review is sought.

Nature of Controversy

Prior to February 1, 1950, taxpayer and 5 other oil companies owned separate producing rights to an oil pool in Kern County, California, known as the 64 Zone. Prior to that date, the companies had engaged in unrestricted competitive production of oil from the Zone. Taxpayer owned two separate properties which overlay the Zone. On one, the Main Property, it had taken percentage depletion because it had already recovered its cost basis. It had taken cost depletion on the other, the Result Property, since that was higher than percentage depletion. Unrestricted competitive production had lowered the gas pressure in the Zone, and on February 1, 1950, the taxpayer and the 5 other oil companies effected a unitization of their property interests in the Zone by an agreement under which each company was to receive a percentage share of total production from the Zone, which production was to be carried on by one company in behalf of all the participants to the agreement. Under the form of the agreement, each participant retained the full right to sell, assign, or otherwise dispose of any of its property interests covered by the agreement, subject only to the production limitations imposed thereby. In computing its allowable depletion for 1950, taxpayer allocated its share of unitized production to its Main and Result Properties, claiming percentage depletion on the former and cost depletion on the latter, as it had done in previous years.

The Commissioner determined that the effect of the unitization agreement was a tax-free exchange

under Section 112(b)(1) by taxpayer of its operating rights in its two separate properties covered by the agreement for a new depletable interest consisting of its share in unitized oil production, which determination had the effect of eliminating any cost depletion for the Result Property after unitization and thus reduced the total amount of depletion claimed by taxpayer on its share of unitized production.

The Tax Court held that taxpayer did not exchange its interest in its two separate properties for a new depletable interest by participating in the unitization agreement, and it is entitled to claim percentage depletion on that part of unitized oil production attributable to its Main Property, and cost depletion on that part attributable to its Result Property.

The issue to be presented for review therefore is: Whether the Tax Court erroneously held that by joining in a unitization agreement for the co-operative operation of all the wells in a certain oil pool, taxpayer did not exchange its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under the unitized operation and is, accordingly, entitled to claim percentage depletion on one and cost depletion on the other as previously claimed by taxpayer.

Although there are no words of conveyance in the agreement involved that each participant retained full right to sell, assign, etc., subject only to the

production limitations imposed by the agreement, and there was no expressed intention on the part of the participants to convey or exchange their economic interest in the Zone, the Supreme Court in many cases has fully prescribed and applied the theory that its "decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type."

It is the position of the Commissioner that the practical consequence of the transaction here, whereby the unitization was accomplished, was exactly the same as though formal contracts of exchange had been executed and, therefore, his treatment of the transaction is the same as prescribed by the Supreme Court. Furthermore, the practical consequence of a unitization agreement is, therefore, that the owner of a larger interest in a small property which has been exchanged for a smaller interest in a larger property no longer looks to the production from the well or wells on his original property but does look to all the wells on a unitized block.

It is, therefore, presented that The Tax Court erred in its holdings herein.

Assignments of Error

The errors upon which the Commissioner relies in this proceeding will be separately filed and served in due course as permitted and provided by the Rules of this Court.

Wherefore, it is prayed that this Honorable Court review the matters set forth herein and to be specifically assigned as error, and correct the errors and reverse the decision of The Tax Court of the United States.

/s/ CHARLES K. RICE, C.A.R.

Assistant Attorney General;

/s/ NELSON P. ROSE, C.A.R.

Chief Counsel Internal Revenue Service, Counsel
for Petitioner on Review.

Of counsel:

C. R. MARSHALL,

Special Attorney

Internal Revenue Service.

Received and filed October 18, 1957, T.C.U.S.

[Title of Court of Appeals and Cause.]

T. C. Docket No. 54288

STATEMENT OF POINTS TO BE
RELIED UPON

The Commissioner of Internal Revenue submits the following Statement of Points upon which he intends to rely as the basis of the petition for review:

That the Tax Court of the United States erred:

1. In failing to hold and decide that taxpayer, as a participant in the unitization agreement, contributed separate operating interest in the 64 Zone in

10. In that its opinion and decision are contrary to the law and the regulations promulgated thereunder and are not supported by substantial evidence of record.

11. In holding and deciding that there is a deficiency in income tax for the year 1950 only in the amount of \$1,246.97.

12. In failing to hold and decide that there is a deficiency in income tax for the year 1950 in the amount of \$33,879.44 and a deficiency in excess profits tax of \$9,866.88.

/s/ CHARLES K. RICE, C.A.R.,
Assistant Attorney General.

/s/ NELSON P. ROSE, C.A.R.,
Chief Counsel Internal Revenue Service, Counsel
for Commissioner of Internal Revenue.

Affidavit of service by mail attached.

Received and filed December 16, 1957. T.C.U.S.

[Title of Tax Court and Cause.]

CERTIFICATE OF CLERK

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 28, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation of Contents of Record," except the original exhibits which are sepa-

rately certified, in the case before The Tax Court of the United States docketed at the above number and in which the respondent in The Tax Court has filed a petition for review as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case, as the same appear in the official docket of my office.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 31st day of December, 1957.

[Seal] /s/ HOWARD P. LOCKE,
Clerk, Tax Court of the
United States.

[Endorsed]: No. 15887. United States Court of Appeals for the Ninth Circuit. Commissioner of Internal Revenue, Petitioner, vs. Belridge Oil Company, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed February 14, 1958.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the
Ninth Circuit.

No. 15888 ✓

United States
Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

FRANK W. BABCOCK,
Respondent.

Transcript of Record

Petition to Review a Decision of the Tax Court
of the United States

FILED

MAR 31 1958

PAUL P. O'BRIEN, CLERK

No. 15888

United States
Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
vs.
FRANK W. BABCOCK,
Respondent.

Transcript of Record

Petition to Review a Decision of the Tax Court
of the United States

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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APPEARANCES

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AUSTIN CLAPP,
1780 Portola Road,
Woodside, California,
For the Respondent.

The Tax Court of the United States

Docket No. 55993

FRANK W. BABCOCK,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1955

Jan. 18—Petition received and filed. Taxpayer notified. Fee paid.

Jan. 20—Copy of petition served on General Counsel.

Jan. 18—Request for Circuit hearing in Los Angeles, Calif., filed by taxpayer. 1/26/55—Granted.

Mar. 11—Answer filed by General Counsel.

Mar. 16—Copy of answer served on Taxpayer—Los Angeles, Calif.

1956

Oct. 19—Hearing set Jan. 7, 1957—Los Angeles, Calif.

Dec. 13—Entry of appearance of Austin Clapp, as counsel, filed.

1957

Jan. 9—Trial had before Judge Atkins, case submitted, Stipulation of Facts, (2 sets), Exhibits 1-A thru 6-F, filed at hearing. Briefs due 3/11/57; Replies due 4/10/57.

1957

Jan. 24—Transcript of Hearing 1/10/57 filed.

Mar. 11—Brief filed by Respondent.

Mar. 12—Motion for extention of time to April 1, 1957, to file brief, and to May 1, 1957, to file reply brief, filed by petitioner. 3/12/57—Granted. Served 3/15/57.

Apr. 3—Brief filed by petitioner. Served 4/3/57.

May 1—Reply Brief filed by petitioner. Served 5/2/57.

June 28—Opinion rendered—Judge Atkins—Decision will be entered under Rule 50. Served 6/30/57.

Aug. 5—Computation filed by petitioner. Served Aug. 6, 1957.

Aug. 6—Hearing set Sept. 11, 1957, Rule 50. Served Aug. 6, 1957.

Aug. 23—Respondent's computation filed. Served 8/27/57.

Aug. 26—Hearing set Sept. 11, 1957, under Rule 50. Served 8/27/57.

Sept. 4—Decision entered—Judge Atkins—Div. 7. Served 9/5/57.

Sept. 6—Agreement to Respondent's computation filed by Petitioner.

Nov. 25—Petition for review by U. S. Court of Appeals, Ninth Circuit, filed by Respondent.

Nov. 25—Statement of Points filed by Respondent.

Dec. 10—Notice of filing petition for review and statement of points with proof of service thereon filed.

1957

Dec. 24—Motion to extend time to and including 2/23/58 for filing record on review and docketing the petition for review filed. Served 12/27/57.

Dec. 26—Order, extending time for filing the record on review and docketing petition for review in the U.S.C.A., 9th Circuit, to 2/23/58, entered. Served 12/27/57.

1958

Jan. 29—Designation of contents of record on review with proof of service thereon filed.

[Title of Tax Court and Cause.]

OPINION

Filed June 28, 1957.

Section 112(f), Internal Revenue Code of 1939—Involuntary Conversion—The property of the petitioner was condemned by the State of California under its power of eminent domain. Part of the award was paid by the state to the holder of a purchase money mortgage upon which the petitioner was not personally liable. The remainder was paid to the petitioner who forthwith invested the amount received by him in similar property. Held that failure of the petitioner to invest in similar property the portion of the money which was paid to the mortgagee does not justify recognition of gain to

the petitioner. Fortee Properties, Inc., 19 T.C. 99, followed.

Tax on Real Estate—Assessment Prior to Acquisition by Petitioner—Real estate taxes assessed in March, and which became a lien at that time, held not deductible by petitioner who later in the year acquired title to the property and paid the taxes. *Magruder v. Supplee*, 316 U.S. 394.

AUSTIN CLAPP, ESQ.,

For the Petitioner.

J. EARL GARDNER, ESQ.,

For the Respondent.

Opinion

Atkins, Judge:

The respondent determined a deficiency in the petitioner's income tax for the calendar year 1949 in the amount of \$15,323.09 and an addition thereto under section 293(a) of the Internal Revenue Code of 1939 in the amount of \$992.38. The petitioner challenges only so much of the deficiency and addition as arises out of the respondent's determination that the petitioner realized a recognizable gain as the result of condemnation of real estate, and that the petitioner is not entitled to a deduction for an amount paid as real estate taxes.

The facts have been stipulated in full and are found as stipulated. A summary of the facts will suffice for the purpose of deciding the issues presented.

I. Gain on Condemnation Award

The petitioner timely filed his income tax return for the calendar year 1949 with the collector of internal revenue at Los Angeles, California.

In October, 1945, the petitioner purchased real estate known as the Elk Metropole Hotel in Los Angeles at a total cost of \$89,600. At the time of purchase he executed a promissory note secured by a purchase money trust deed (sometimes referred to herein as "mortgage"), covering the land and building in the amount of \$70,000. Principal and accrued interest on that note aggregating \$57,572.63 remained unpaid on November 9, 1949. Interest paid by the petitioner on the note from October 1, 1945, to November 9, 1949, was claimed and allowed as a deduction from gross income in income tax returns filed during that period.

On November 9, 1949, the State of California, under condemnation proceedings, acquired the Elk Metropole Hotel, pursuant to a formal contract entered into between the petitioner and the State of California, which fixed the selling price at \$207,323.34. On or about the same date, and in accordance with the contract,¹ the State of California

¹The contract between the petitioner and the State provided that the State should pay the petitioner, as grantor, \$207,323.34 for the property, payment to be made within 90 days after the date title vested in the State free and clear of all liens and encumbrances. However, it was further provided that, upon demand, any or all of the moneys up to

paid to the mortgagee of the property the sum of \$57,572.63 representing the balance due on the trust deed note, and also paid directly to the petitioner the sum of \$149,750.71, which payments aggregated the contract price of \$207,323.34.

In March, 1950, an informal application to establish a replacement fund was made by the petitioner to the respondent. While this was pending, on July 7, 1950, the petitioner purchased the Sherwood Apartment Hotel in Los Angeles as a replacement of the Elk Metropole Hotel. The purchase price of the replacement property was \$186,125 of which \$149,750.71 was paid in cash by the petitioner from the moneys received from the State of California for the Elk Metropole Hotel property.

In his income tax returns for the years 1945 to 1949, inclusive, the petitioner claimed depreciation deductions in respect of the Elk Metropole Hotel in the aggregate amount of \$8,166.66, of which the respondent allowed the amount of \$8,000.

In his notice of deficiency the respondent held that since only \$186,125 was expended by the petitioner for similar property, whereas the amount of

and including the total amount of the unpaid principal and interest on the note secured by the deed of trust, together with any penalty for payment in full in advance of maturity, should be made payable to the beneficiary under the deed of trust, and that such beneficiary should furnish the grantor (the petitioner) with good and sufficient receipts showing such money credited against the indebtedness secured by the deed of trust.

the condemnation award was \$207,323.34, gain is recognizable to the extent of the difference of \$21,198.34. He treated this as long-term gain and increased the reported taxable income by one-half that amount, or \$10,599.17.

The substance of the petitioner's argument against the recognition of any gain arising out of the condemnation award is that his interest in the property and the interest of the mortgagee were several interests, that he sold only his interest, and that the amount he realized for his interest was fully reinvested in similar property; hence under section 112(f) of the 1939 Code there was no recognizable gain. The computation that he purposes on brief is as follows:

Down payment	\$ 19,600.00
Payments on principal.....	12,427.37
<hr/>	
Cost of interest sold.....	\$ 32,027.37
Capital returned via depreciation.....	8,000.00
<hr/>	
Basis of interest sold.....	\$ 24,027.37
Gain realized	125,723.34
<hr/>	
Total realized	\$149,750.71
Reinvested	\$149,750.71
<hr/>	
Gain recognized	

Section 112(f) as it existed in 1949 provided as follows:

Involuntary Conversions—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

Section 29.112(f)-1 of Regulations 111 provides in part as follows:

If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property and itself pays the same, the amounts so retained shall not be de-

ducted from the gross award in determining the amount of the net award. * * *

In *Fortee Properties, Inc.*, 19 T.C. 99, certain properties of the taxpayer were taken by the Port of New York Authority by condemnation under the power of eminent domain. Each of the properties was encumbered by mortgages which had been placed thereon prior to the time the taxpayer had acquired them. The taxpayer had not assumed the liability but had acquired the properties subject to the mortgages. The taxpayer and the Port of New York Authority agreed upon the total value of the properties. The Authority paid the amount due on the mortgages directly to the holder and paid the balance to the taxpayer. The taxpayer had no control over the payment or disposition of the amount paid in satisfaction of the mortgages. In that case it was held that the taxpayer, by investing the full amount of money which was paid directly to it, had complied with the provisions of section 112(f) and that it was not necessary to such compliance that it also expend in the acquisition of similar property an amount equal to the amount which was directly paid by the Port of New York Authority to the holder of the mortgages. It was pointed out that the taxpayer had not borrowed the money secured by the mortgages, did not receive directly, indirectly or constructively the amount necessary to satisfy the mortgages, and since it was not personally liable for the mortgage indebtedness, did not benefit by the payment of

such indebtedness. Certain cases were distinguished on the ground that therein money awarded was used by the Government to pay liens placed upon the property during the time it was owned by the taxpayer or to pay a debt for which the taxpayer was personally liable. In that case we stated in part:

* * * If his (the Commissioner's) regulation is intended to cover a case like this one in which the petitioner was not personally liable for the mortgages, then to that extent the regulation is invalid because it frustrates rather than promotes the intention of Congress.

* * *

* * * The rather clear intention of Congress would be defeated rather than carried out if a part of the petitioner's gain were to be recognized because it did not also expend in the acquisition of similar property the \$28,970 which it did not have invested in the condemned property, for the payment of which it was not personally liable, and which it did not receive directly, indirectly, or constructively. * * *

That case was reversed in *Commissioner v. Fortee Properties, Inc.*, (C.A. 2, 1954) 211 F. 2d 915, cert. denied 348 U. S. 826. The Court of Appeals in holding in effect that the taxpayer had not complied with the requirements of section 112(f), took the view that, within the meaning of that section, the property sold was the full property and not merely the owner's rights over and above encumbrances,

and that the payment to the mortgagee, even though liability had not been assumed by the taxpayer, benefitted it. In so holding the Court of Appeals relied heavily upon *Crane v. Commissioner* 331 U.S. 1.

In our consideration of the *Fortee* case we gave thorough consideration to the *Crane* case and held that it had no application since it did not involve section 112(f) of the Code. In the *Crane* case the question presented was how a taxpayer, who acquired depreciable property subject to an unassumed mortgage, held it for a period, and finally sold it, still so encumbered, must compute the taxable gain. We were not concerned with any such question in the *Fortee* case. We were concerned with the question whether the taxpayer had invested in similar property all the money received upon the involuntary conversion of his former property so as to comply with the provisions of section 112(f). We have given careful consideration to the holding of the Court of Appeals for the Second Circuit in the *Fortee* case, but with all due respect to that court we adhere to the position taken by us in that case.

We have not overlooked the following statement contained in H. Rept. No. 798, 82nd Cong., 1st Sess., made in connection with Public Law 251, 82nd Cong., Act of Oct. 31, 1951, 65 Stat. 733, 1951-2 C.B. 353, which amended section 112(f):

* * * A problem also arises under the present law where the taxpayer uses a part of the pro-

ceeds from the converted property to pay off indebtedness on the converted property. In such a case the taxpayer is denied the benefits of section 112(f), that is, the taxpayer must pay a tax on any gain from the converted property up to the amount of the proceeds which are used in liquidation of indebtedness on the converted property, even though he also fully replaces the converted property, since the amount used to pay off the indebtedness cannot be directly traced into the replacement property.

In such a case as the instant case and the Fortee case, where an amount is paid to the mortgagee under a mortgage as to which the taxpayer has no personal liability, we think the money so used should not be considered as money received by the taxpayer. Cf. *Kennebec Box & Lumber Co., Inc., v. Commissioner* (C.A. 1), 168 F. 2d 646, and *Ovider Realty Co. v. Commissioner* (C.A. 4), 193 F. 2d 266, both affirming decisions of this Court.

There is no essential difference between the in-state case and the Fortee case. The petitioner, under the condemnation procedure, entered into an agreement with the State of California fixing the amount of the award at \$207,323.34, and the State of California directly paid off the mortgage indebtedness out of the \$207,323.34. Here, although the mortgage was placed upon the property by the petitioner at the time of purchase, there was no personal liability

upon him for payment thereof, the mortgagee having recourse only against the property, in view of sections 580b and 580d of the California Code of Civil Procedure (West's Annotated California Codes, vol. 16, pp. 57 and 60),² as construed in *Stone v. Lobsien*, 112 Cal. App. 2d 750, 247 P. 2d

²§ 580b. Purchase money mortgages, etc.; no deficiency judgment.

No deficiency judgment shall lie in any event after any sale of real property for failure of the purchaser to complete his contract of sale, or under a deed of trust, or mortgage, given to secure payment of the balance of the purchase price of real property.

Where both a chattel mortgage and a deed of trust or mortgage have been given to secure payment of the balance of the combined purchase price of both real and personal property, no deficiency judgment shall lie at any time under any one thereof. * * *

§ 580d. Foreclosure under power of sale; no deficiency judgment; exceptions:

No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property hereafter executed in any case in which the real property has been sold by the mortgagee or trustee under power of sale contained in such mortgage or deed of trust.

The provisions of this section shall not apply to any deed of trust, mortgage or other lien given to secure the payment of bonds or other evidences of indebtedness authorized or permitted to be issued by the Commissioner of Corporations, or which is made by a public utility subject to the provisions of the Public Utilities Act. * * *

357, and Mortgage Guarantee Co. v. Sampsell, 51 Cal. App. 2d 180, 124 P. 2d 353³.

We accordingly hold that the respondent erred in treating any part of the condemnation award as a recognizable gain.

II. Deductibility of Real Estate Taxes

On or about February 14, 1949, the petitioner entered into an escrow agreement for the purchase of certain real property in block 38, Hancock's Survey in the City and County of Los Angeles, California. On the first Monday in March, 1949, taxes were assessed in the name of the record owner, Fridi Seeber, against the property by the authorities of Los Angeles County. The terms of the escrow agreement were satisfied and settlement was made by the parties on April 4, 1949. In December, 1949, the petitioner paid taxes in the

³In *Stone v. Lobsien* it was stated:

* * * This was a purchase money deed of trust, and, in this state, there is no personal liability imposed on the vendee of a purchase money deed of trust. In the event of a default, no deficiency judgment could have been taken against appellant. § 580b, Code Civ. Proc.; * * *

In *Mortgage Guarantee Co. v. Sampsell* it was stated:

* * * Section 580b, which is the section upon which appellant relies in this case, states, in effect, that there can be no deficiency judgment at all where property is sold under a purchase money mortgage or deed of trust. In other words, for a purchase money mortgage or deed of trust the security alone can be looked to for recovery of the debt. * * *

amount of \$862.30 which had been assessed against the property on the first Monday in March, 1949, while in escrow. The petitioner in his income tax return for the calendar year 1949 claimed a deduction for such payment of \$862.30. The respondent disallowed the deduction on the ground that these taxes were imposed upon the seller and that the payment by the petitioner constituted a capital expenditure.

In *Magruder v. Supplee*, 316 U.S. 394, the Supreme Court, in deciding whether a vendee of real property was entitled to deduct state and city real property taxes stated:

* * * A tax lien is an encumbrance upon the land, and payment, subsequent to purchase, to discharge a pre-existing lien is no more the payment of a tax in any proper sense of the word than is a payment to discharge any other encumbrance, for instance a mortgage. * * *

* * *

Thus, either a pre-existing tax lien or personal liability for the taxes on the part of a vendor is sufficient to foreclose a subsequent purchaser, who pays the amount necessary to discharge the tax liability, from deducting such payment as a "tax paid." * * *

That case also establishes that in ascertaining the existence of either a personal liability for the tax on the part of a vendor or the existence of a lien

prior to the time of purchase thereof resort must be had to the law of the taxing authority.

The State of California Revenue and Taxation Code (West's Annotated California Codes, vol. 59, pp. 204, 334 and 341) provides in pertinent parts as follows:

§ 405. Annual assessment; time

Annually, the assessor shall assess all the taxable property in his county, except State assessed property, to the persons owning, claiming, possessing, or controlling it at 12 o'clock meridian of the first Monday in March. The assessor shall ascertain such property between the first Mondays in March and July. * * *

§ 2187. Tax on real estate; lien

Every tax on real property is a lien against the property assessed. * * *

§ 2192. Lien date

All tax liens attach annually as of noon on the first Monday in March preceding the fiscal year for which the taxes are levied. * * *

In view of these provisions of the statute it seems clear that the property taxes in question are those for the state's fiscal year ended June 30, 1950, but that a lien on account thereof attached to the property as of the first Monday in March, 1949. At that time the conditions of the escrow agreement had not been met and title to the property had not passed to the petitioner.

The petitioner first contends that the equitable owner of the property is personally liable for the tax and may be assessed for it, relying upon the case of *First Trust & Savings Bank of Pasadena v. Los Angeles County*, 206 Cal. 240, 273 Pac. 1066. The petitioner has cited no case, nor has any come to our attention, under which it could be considered that the petitioner obtained an equitable title to the property under the escrow agreement. Insofar as we can determine, neither equitable nor legal title passed from the original owner prior to the settlement on April 4, 1949.

The petitioner also contends that he should be considered as claiming and controlling the property on the first Monday in March, 1949, within the meaning of section 405 of the Revenue and Taxation Code quoted above. He has cited us no authority to support this contention and we have been unable to find any. Normally an escrow agreement, as we understand it, does not give the vendee control over the property or a claim to it prior to the satisfaction of the terms of the escrow.

We have held that under the laws of California the liability for property taxes is determined by the ownership of the property on the first Monday in March. *California Sanitary Co., Ltd.*, 32 B.T.A. 122, *Crown Zellerbach Corporation*, 43 B.T.A. 541, *Pacific Southwest Realty Co.*, 45 B.T.A. 426 (affirmed on other issues (C.A. 9), 128 F. 2d 815).

Here we think the petitioner was not, on the first Monday of March, 1949, the person owning.

claiming, possessing or controlling the property within the meaning of the California statute and that hence the taxes were not imposed upon him. Rather, we believe that when he did become the owner of the property it was impressed with a lien and that his discharge of such lien constituted a capital expenditure in the nature of additional cost of the land to him and that he is not entitled to deduct the amount of \$862.30 as taxes paid, under section 23(c) of the Internal Revenue Code of 1939.

The respondent determined an addition to the tax under section 293(a) in the amount of \$992.38. The petitioner does not allege error in the respondent's assertion of the addition, but does question the amount thereof. Section 293(a) provides:

Negligence—If any part of any deficiency is due to negligence, or intentional disregard of rules and regulations but without intent to defraud, 5 per centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected, and paid in the same manner as if it were a deficiency, * * *.

The proper amount of the addition to tax will be fixed pursuant to the computation under Rule 50.

Decision will be entered under Rule 50.

Served: June 30, 1957.

Entered: June 30, 1957.

Tax Court of the United States

Docket No. 55993

FRANK W. BABCOCK,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion filed June 28, 1957, the petitioner herein, on August 5, 1957, filed a recomputation for entry of decision, and the respondent herein, on August 23, 1957, filed a recomputation for entry of decision. The above recomputations are in agreement, and therefore, it is

Ordered and Decided: That there is a deficiency in income tax in the amount of \$4,161.77 for the taxable year 1949, and additions to tax under section 293(a), Internal Revenue Code of 1939, in the amount of \$727.40.

Entered: September 4, 1957.

[Seal] /s/ CRAIG S. ATKINS,
Judge.

Served: September 5, 1957.

Entered: September 5, 1957.

reported and allowed as a deduction from gross income in his income tax returns covering this period.

7. On November 9, 1949, the State of California, under condemnation proceedings, acquired said real property pursuant to a formal contract entered into between the petitioner and the State of California dated July 21, 1949, fixing the selling price at \$207,323.34. Also, on or about November 9, 1949, and in accordance with the provisions of the contract dated July 21, 1949, the State of California paid the mortgagee the balance due on the trust deed note of \$57,572.63 and paid directly to the petitioner \$149,750.71 for a total payment of \$207,323.34. Attached as Exhibits 5-E and 6-F, respectively, are copies of the contract to purchase dated July 21, 1949, and the receipt retained by the State of California for the payment of \$149,750.71 to Frank W. Babcock dated November 9, 1949.

8. Between November 9, 1949, and March, 1950, petitioner endeavored to find a suitable replacement property.

9. In early March, 1950, an informal application to establish a replacement fund was made by petitioner to the Commissioner of Internal Revenue, and while this was pending, a suitable replacement was found in the Sherwood Apartment Hotel, 431 South Grand Avenue, Los Angeles, California, which was purchased by petitioner for \$186,125.00, of which \$149,750.71 was paid in cash by the petitioner from the moneys received from the State

of California for the Elk Metropole property. The purchase of the Sherwood Apartment Hotel was made on or about July 7, 1950.

10. Section 580a, Code of Civil Procedure for the State of California provides in part as follows:

“Whenever a money judgment is sought for the balance due on an obligation for the payment of which a deed of trust or mortgage with power of sale upon real property or any interest therein was given as security, the court may render judgment for not more than the amount by which the entire amount of the indebtedness due at the time of sale exceeded the fair market value of the real property or interest therein sold at the time of sale with interest thereon from the date of the sale; provided, however, that in no event shall the amount of said judgment, exclusive of interest after the date of sale, exceed the difference between the amount for which the property was sold and the entire amount of the indebtedness secured by said deed of trust or mortgage.”

/s/ AUSTIN CLAPP,

Counsel for Petitioner.

/s/ JOHN POTTS BARNES, R.E.M.

Chief Counsel, Internal Revenue Service, Counsel
for Respondent.

EXHIBIT 4-D

Escrow Instructions

Los Angeles, California

Escrow No. 2227-822-jj/jr

August 3, 1945

Title Insurance and Trust Company:

On or before Sept. 30, 1945, I will hand you the sum of \$24,000.00, plus funds sufficient to cover my charges and prorations herein, together with the note and deed of trust for \$70,000.00 set forth below, and the chattel mortgage, and I hand you herewith check for \$1000.00, all of which you will deliver when you obtain and record for me a deed to vestee and covering property described below, and when you can issue your usual form—standard form—policy of title insurance with liability not exceeding \$95,000.00 on all of Lot 2 and fractional Lots 1, 11 and 12 in Block 106, of the Bellevue Terrace Tract, in the City of and County of Los Angeles, State of California, being a Tract of land bounded as follows: On the North by the North line of said Lots 2 and 12 of said Block 106; on the East of Fremont Avenue and on the South and West by Sixth Street, as per map recorded in Book 2 Page 585 of Miscellaneous Records, showing title vested in Frank W. Babcock, an unmarried man.

Subject only to:

- (1) All taxes for the fiscal year 1945-1946.

(2) Covenants, conditions, restrictions, and easements of record: (Subject to approval of buyer.)

(3) Deed of trust to file, any form, executed by vestee above, securing a note for \$70,000.00, in favor of Call Estate Co., a corporation, with interest from date of note at $4\frac{1}{2}\%$ per annum, principal and interest payable in installments of \$535.00 or more per month, until paid, payable at Los Angeles, California.

Said trust deed to recite that it is given to secure a portion of the purchase price of the property in question.

Said note is also secured by a chattel mortgage on personal property, given as additional security therefor.

Pro rate as of date of close of escrow the following:

(a) Taxes based on second half taxes for 1944-1945.

(b) Insurance premium on policy or policies as handed you.

(c) Rents on 30-day basis, based on statement to be handed you, which statement is subject to my approval.

Do not draw note, trust deed or chattel mortgage. My execution of all of said documents will evidence my approval in full of all terms, contents and provisions thereof.

Endorse interest on above note as paid to date of close of escrow.

Also obtain for delivery to me at close of escrow without additional consideration, a bill of sale covering certain personal property on the premises in question, per inventory attached, which bill of sale and inventory I reserve the right to approve. No chattel search required. Title Insurance and Trust Company is liable only for the delivery of said document at close of escrow.

Also obtain for delivery to me at close of escrow the following leases, together with assignments of the seller's interest therein, which leases I reserve the right to approve:

(1) Lease in favor of Boris Pollack and assigned to Oscar Plotkin and Aaron Gordon; and

(2) Lease in favor of Harry Rasnick.

Deliver title insurance policy to beneficiary.

Instruct Recorder to mail deed to me; trust deed & chat. mtg. to beneficiary. I pay your buyer's service fee as charged; recording deed \$1.00; mortgagee's clause on ins. 25 cents each.

General Provisions

“All funds received in this escrow shall be deposited with other escrow funds in a general escrow account of Title Insurance and Trust Company with the Farmers and Merchants National Bank of Los Angeles. All disbursements shall be made by check of Title Insurance and Trust Company.

Recordation of any instruments delivered through this escrow, if necessary or proper in the issuance of the policy of title insurance called for, is authorized.

No examination or insurance as to the amount or payment of real or personal property taxes is required unless the real property tax is payable on or before the date of the policy of title insurance.

Execute on behalf of the parties hereto, form assignments of interest in any insurance policies (other than title insurance) called for herein and forward them upon close of escrow to the agent with the request, first, that insurer consent to such transfer or attach loss-payable clause or make such other additions or corrections as may have been specifically required herein, and second, that the agent thereafter forward such policies to the parties entitled to them. In all acts in this escrow relating to fire insurance, including adjustments, if any, you shall be fully protected in assuming that each such policy is in force and that the necessary premium therefor has been paid.

Time is of the essence of these instructions. If this escrow is not in condition to close by September 30, 1945, any party who then shall have fully complied with his instructions may, in writing, demand the return of his money and/or property; but if none have complied no demand for return thereof shall be recognized until five days after the escrow holder shall have mailed copies of such demand to all other parties at their respective addresses shown

in the escrow instructions. If no such demand is made close this escrow as soon as possible.

Any amendment of or supplement to any instructions must be in writing."

Buyer:

/s/ FRANK W. BABCOCK,
834 So. Main,
Los Angeles, California.

August 3, 1945.

Title Insurance and Trust Company:

I have read and approve the foregoing instructions. On or before September 30, 1945, I will hand you deed and bill of sale, together with the two leases and assignments, all as called for on page 1 hereof, which you will deliver when you can issue the policy of title insurance called for and collect for the account of the grantor the sum of \$25,000.00, and obtain and record for the undersigned the note for \$70,000.00 and deed of trust and chattel mortgage securing it as set forth on page 1 hereof.

Do not draw deed.

Pay at the close of escrow the sum of \$4250.00 to N. M. Saunders, 1109 I. N Van Nuys Building, Los Angeles, California; License No. 17317, as commission and debit the account of the undersigned accordingly.

The foregoing General Provisions are hereby incorporated in these instructions.

Pay all incumbrances of record necessary to place title in the condition called for. I will hand you any funds and instruments required for such purpose.

Deliver title insurance policy to us.

Instruct recorder to mail trust deed & chat. mtg to us; deed to grantee.

Begin search of title at once. I pay policy fee and escrow fee, both as charged; recording deed of trust & chattle mortgage. Internal Revenue Stamps of \$104.50, insurance transfers 25 cents each.

CALL ESTATE CO.

By /s/ [Indistinguishable.]

EXHIBIT "5-E"

FORM R.W.-1

Los Angeles California
July 21 1949

ACCT.	DIST.	COUNTY	ROUTE	SECTION	ALLOT
	VII	LA	165	LA	7RV50

FRANK W. BABCOCK,
an unmarried man,
 Grantor

Station _____ to station _____

Side of Highway.

W. v. Clare Schuchter
557295
 Par No. 14

RIGHT OF WAY CONTRACT—STATE HIGHWAY

Document No. 785 in the form of a Grant Deed

covering the following described property:

Lots 1, 2, 11 and 12 in Block 106 of the Bellevue
 Terrane Tract, as per map recorded in Book 2,
 Page 585, of Miscellaneous Records of Los Angeles
 County, as more fully described in above-mentioned
 Grant Deed,

APPROVED

JUL 30 1949

BY [Signature]
 NO. R/W OFFICE

has been executed and delivered to E. F. KING

Right of Way Agent of the State of California.

In consideration of which, and the other considerations hereinafter set forth, it is mutually agreed as follows:

1. The parties have herein set forth the whole of their agreement. The performance of this agreement constitutes the entire consideration for said document and shall relieve the State of all further obligation or claims on this account, or on account of the location, grade or construction of the proposed public improvement.

2. The State shall:

(A) Pay the undersigned grantor the sum of \$207,323.34 for the property as conveyed by Grant Deed No. 785 within ninety (90) days after date title to said property vests in the State free and clear of all liens, encumbrances, assessments and recorded and/or unrecorded leasehold interests and easements except:

a. General and special City and County taxes for the fiscal year 1949-50, a lien not yet payable.

(B) Pay all escrow and recording fees incurred in this transaction, and, if title insurance is desired by the State, the premium charged therefor. Said escrow and recording charges shall not, however, include reconveyance fees, trustee's fees, or forwarding fees.

3. Any or all moneys payable under this contract, up to and including the total amount of unpaid principal and interest on the note secured by deed of trust recorded October 11, 1945 in Book 22244, Page 323, Official Records of Los Angeles County, together with penalty (if any) for payment in full in advance of maturity, shall, upon demand, be made payable to the beneficiary entitled thereunder; said beneficiary furnish grantor with good and sufficient receipt showing said moneys credited against the indebtedness secured by said deed of trust.

4. All rents shall be pro-rated as of October 31, 1949. All rents derived from said property up to and including said date shall be paid to the grantor and all rents paid for occupancy after said date shall be paid to the State of California. If any rentals on said property have been or ~~are~~ collected by the undersigned grantor for any period beyond said date, the undersigned grantor for any period beyond said date, the undersigned grantor shall immediately refund such rentals to the State.

5. The undersigned grantor hereby agrees and consents to the dismissal of Parcel No. 14, People vs. Clare Schweitzer, Superior Court Case No. 557295, Los Angeles County, and also waives any and all claims to any money that may have been deposited in the Superior Court in said action.

6. Grantor hereby ^{and operated} agrees to deliver up possession of premises ^{now} ~~now~~ occupied by him, i.e., Elk Hotel, 947-949 West Sixth Street; Metropole Hotel, 931-933 West Sixth Street; and rooming house, 941-943 1/2 West Sixth Street by October 31, 1949 and, to that end, will immediately make application to the OPA for eviction of present tenants and take such other steps as will be necessary to deliver premises vacant on above date.

IN WITNESS WHEREOF, the parties have executed this agreement the day and year first above written.

Frank W. Saunders

C/O N. W. Saunders Co.

1100 I. N. Van Nuys Bldg.

~~834 South Main Street~~
Los Angeles, California

Grantor

Recommended for Approval

By *[Signature]*
Right of Way Agent

Recommended for Approval,

By *HW Leonard*
Metropolitan District Right of Way Agent

STATE OF CALIFORNIA
DEPARTMENT OF PUBLIC WORKS
DIVISION OF HIGHWAYS

By *A. D. Griffin*
Asst. District Engineer

No Obligation Other Than Those Set Forth Herein Will Be Recognized

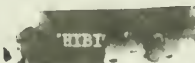


EXHIBIT "6-F"

County: LA

Route: 165

Section: LA

Parcel No.: 785—Babcock

Received from the State of California, Dept. of Public Works, Division of Highways, Check No. Y78771, in the amount of \$149,750.71, covering payment in accordance with Right of Way Contract dated July 21, 1949.

/s/ FRANK W. BABCOCK.

Dated at Los Angeles, California, November 9, 1949.

Filed at hearing January 10, 1957.

[Title of Tax Court and Cause.]

ADDITIONAL STIPULATION OF FACTS

It is stipulated that the following facts may be received in evidence without further proof; provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts stipulated; and provided, further

that both parties to this stipulation reserve the right to object to the materiality and relevancy of any of the facts herein stipulated.

11. Section 580b, Code of Civil Procedure for the State of California, provides as follows:

“No deficiency judgment shall lie in any event after any sale of real property for failure of the purchaser to complete his contract of sale or under a deed of trust, or mortgage, given to secure payment of the balance of the purchase price of real property.

“Where both a chattel mortgage and a deed of trust or mortgage have been given to secure payment of the balance of the combined purchase price of both real and personal property, no deficiency judgment shall lie at any time under any one thereof.”

12. Section 580d, Code of Civil Procedure for the State of California, provides in part as follows:

“No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property hereafter executed in any case in which the real property has been sold by the mortgagee or trustee under power of sale contained in such mortgage or deed of trust. * * *”

13. That the amount of depreciation claimed by petitioner in his federal income tax returns for the years 1945, 1946, 1947, 1948 and 1949 was the sum

of \$8,166.66 of which the sum of \$8,000.00 was allowed by Respondent.

/s/ AUSTIN CLAPP,
Counsel for Petitioner.

/s/ JOHN POTTS BARNES, R.E.M.
Chief Counsel, Internal Revenue Service, Counsel
for Respondent.

Filed at hearing January 10, 1957.

In the United States Court of Appeals
for the Ninth Circuit

T. C. Docket No. 55993

COMMISSIONER OF INTERNAL REVENUE,
Petitioner on Review,

vs.

FRANK W. BABCOCK,
Respondent on Review.

PETITION FOR REVIEW

To the Honorable Judge of the United States Court
of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by The Tax Court of the United States on September 4, 1957. ordering and deciding that there is a

deficiency in income tax in the amount of \$4,161.77 for the taxable year 1949 and additions to tax under section 293(a), Internal Revenue Code of 1939, in the amount of \$727.40. This petition for review is filed pursuant to the provisions of sections 7482 and 7483 of the Internal Revenue Code of 1954.

The respondent on review (hereinafter referred to as the taxpayer) resides at 501 S. Los Angeles Street, Los Angeles, California. The taxpayer filed his income tax return for the calendar year 1949 with the Collector of Internal Revenue at Los Angeles, California, and within the judicial circuit of the United States Court of Appeals for the Ninth Circuit, wherein this review is sought.

Nature of Controversy

The question involved is whether the gain of a taxpayer whose property is taken pursuant to condemnation proceedings is recognized to the extent of an amount retained by the Government and used to pay taxpayer's note secured by a mortgage against the property.

The substance of taxpayer's argument against the recognition of any gain arising out of the condemnation award is that his interest in the property and the interest of the mortgagee were several interests, that he sold only his interest, and that the amount he realized for his interest was fully re-invested in similar property; hence under section 112(f) of the 1939 Internal Revenue Code there was no recognizable gain.

The Commissioner took the position that the word “property” as used in section 112(f), relating to involuntary conversions, does not mean merely taxpayer’s equitable interest, but also includes amounts used to pay taxpayer’s note secured by a mortgage against the involuntarily converted property under section 29.112(f)-1 of Treasury Regulations 111 and *Fortee Properties, Inc., v. Commissioner* (C.A. 2, 1954) 211 F.2d 915; 45 A.F.T.R. 1347, with the result that the gain is recognizable to the extent of such amount.

/s/ CHARLES K. RICE, C.A.R.
Assistant Attorney General.

/s/ NELSON P. ROSE, C.A.R.
Chief Counsel, Internal Revenue Service, Counsel
for Petitioner on Review.

Received and filed November 25, 1957, T.C.U.S

[Title of Court of Appeals and Cause.]

T. C. Docket No. 55993

STATEMENT OF POINTS

Comes Now the petitioner on review herein and makes this concise statement of points on which he intends to rely on the review herein, to wit:

The Tax Court of the United States erred:

1. In holding that failure of the taxpayer to invest in similar property the amount of money re-

tained by the Government in condemnation proceedings and used to pay taxpayer's note secured by a mortgage against the condemned property, did not justify recognition of gain to the taxpayer.

2. In failing to hold that taxpayer's failure to invest in similar property the amount of money retained by the Government in condemnation proceedings and used to pay taxpayer's note secured by a mortgage against the condemned property, rendered the gain taxable to the extent of such amount.

3. In holding that there is a deficiency in income tax for the year 1949 in the amount of \$4,161.77 and additions to tax under section 293(a), Internal Revenue Code of 1939, in the amount of \$727.40.

4. In failing to hold that there is a deficiency in income tax for the year 1949 in the amount of \$15,323.09 and additions to tax under section 293(a), Internal Revenue Code of 1939, in the amount of \$992.38.

5. In that its opinion and decision are contrary to law and regulations and are not supported by its finding of fact or substantial evidence.

/s/ CHARLES K. RICE, C.A.R.
Assistant Attorney General.

/s/ NELSON P. ROSE, C.A.R.
Chief Counsel, Internal Revenue Service, Counsel
for Petitioner on Review.

Received and filed November 25, 1957, T.C.U.S.

[Title of Tax Court and Cause.]

CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 12, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation of Contents of Record on Review," including joint exhibits 1-A thru 6-F, attached to the Stipulation of Facts, in the case before the Tax Court of the United States docketed at the above number and in which the Respondent in the Tax Court has filed a petition for review as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case, as the same appear in the official docket in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 10th day of February, 1958.

[Seal] /s/ HOWARD P. LOCKE,
Clerk, Tax Court of the
United States.

[Endorsed]: No. 15888. United States Court of Appeals for the Ninth Circuit. Commissioner of Internal Revenue, Petitioner, vs. Frank W. Babcock, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed: February 17, 1958.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the
Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FRANK W. BABCOCK, RESPONDENT

On Petition For Review of The Decision of The
Tax Court of The United States

BRIEF FOR THE PETITIONER

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
ROBERT N. ANDERSON,
LOUISE FOSTER,
Attorneys,
Department of Justice,
Washington 25, D. C.

FILED

MAY 6 1958

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**In the United States Court of Appeals
for the Ninth Circuit**

No. 15,888

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FRANK W. BABCOCK, RESPONDENT

On Petition For Review of The Decision of The
Tax Court of The United States

BRIEF FOR THE PETITIONER

OPINION BELOW

The opinion of the Tax Court (R. 5-20) is reported at 28 T.C. 781.

JURISDICTION

The Commissioner determined a deficiency in the taxpayer's income tax for 1949 in the amount of \$15,323.09 and an addition thereto under 1939 Code Section 293(a) in the amount of \$992.38. (R. 6.) On January 18, 1955, which was within the ninety-day period allowed by the statute, the taxpayer filed a petition in the Tax Court for redetermination of

such deficiency under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 3.) After the hearing, the Tax Court decided on September 4, 1957, that there is a deficiency in income tax only in the amount of \$4,161.77 for 1949, and also decided there should be additions to tax under Section 293(a) in the amount of \$727.40. (R. 21.) Within three months thereafter, i.e., on November 25, 1957, a petition for review by this Court was filed by the Commissioner. (R. 37-39.) Jurisdiction of this Court is invoked under Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the taxpayer realized taxable gain under 1939 Code Section 112(f) to the extent of the difference between the total award paid upon the condemnation of the taxpayer's property and a smaller amount subsequently invested by the taxpayer in replacement property. This depends on whether the taxpayer, who was not personally liable on the mortgage covering the condemned property and who actually did not receive the amount used to pay off the mortgage must treat the whole amount of the award as the selling price, as the Commissioner determined; or is required to treat only the amount of his equity in the property as such price (which was less than the amount he reinvested), as the Tax Court held.

STATUTE AND REGULATIONS INVOLVED

The pertinent statutory provisions and regulations appear in the Appendix A, *infra*.

STATEMENT

The facts so far as pertinent to the issue here were found by the Tax Court as follows (R. 7-9) :

In October, 1945, the taxpayer purchased real estate known as the Elk Metropole Hotel in Los Angeles at a total cost of \$89,600 and at the time of purchase he executed a promissory note secured by a mortgage, covering the land and building, in the amount of \$70,000. On November 9, 1949, unpaid principal and interest on that note aggregated \$57,572.63. Interest which had already been paid was claimed and allowed as a deduction on income tax returns filed during that period. (R. 7.)

On November 9, 1949, the State of California acquired the Elk Metropole Hotel under condemnation proceedings and pursuant to a formal contract with the taxpayer agreed that the selling price would be \$207,323.34. At the same time and in accordance with the contract the State paid the mortgagee \$57,572.63 (which was the balance due on the note) and paid the remainder of the selling price or \$149,750.71, to the taxpayer. (R. 7-8.)

In March, 1950, the taxpayer made an informal application to establish a replacement fund and on July 7, 1950, while such application was still pending, the taxpayer purchased the Sherwood Apartment Hotel as a replacement of the Elk Metropole Hotel. The purchase price of the replacement property was \$186,125 of which \$149,750.71 was paid by taxpayer in cash from the money received from the State for the other hotel. (R. 8.)

In his notice of deficiency, the Commissioner held that since only \$186,125 was spent by the taxpayer for similar property and \$207,323.34 has been paid as the total condemnation award, the difference between these two figures should be treated as gain (i.e., long term capital gain); and so he increased the taxable income by one half of the resulting figure or by \$10,599.17. (R. 8-9.)

The Tax Court refused to approve the Commissioner's determination, and held that no part of the condemnation award constituted a taxable gain. (R. 16.) Two other issues were decided for the Government and need not be considered here.

STATEMENT OF POINTS TO BE URGED

1. The Tax Court erred in holding that failure of the taxpayer to invest in similar property the amount of money retained by the State Government in condemnation proceedings and used to pay taxpayer's note secured by a mortgage against the condemned property did not justify recognition of gain to the taxpayer.

2. The Tax Court erred in failing to hold that there is a deficiency in income tax for the year 1949 in the amount of \$15,323.09 and additions to tax under Section 293(a), Internal Revenue Code of 1939, in the amount of \$992.38.

3. The Tax Court's opinion and decision are contrary to the law and Regulations pertinent thereto.

SUMMARY OF ARGUMENT

Taxpayer realized taxable gain upon the condemnation of his hotel by the State of California unless the

transaction falls within the non-recognition provisions of the statute, which require that all the money paid by the purchaser upon the conversion of the property into cash be used for acquiring suitable replacement property forthwith. Consequently, as the record shows that part of the award was not used in the acquisition of the replacement property, the statutory requirement has not been met and gain, to the extent of the money not so used, must be recognized for income tax purposes.

This view is in accord with the long standing Regulations which now have the force of law and which provide that the amount of the net award shall include any sum retained by the Government to satisfy any mortgages on the property even if the Government pays the mortgagee itself. These Regulations have been approved and followed in the applicable decisions of the Court of Appeals. But the Tax Court tried to avoid the implication of these decisions by holding here that the principle announced therein should be applied only in cases where the taxpayer has assumed the mortgage and can not be applied in this case because the taxpayer has no personal obligation for the mortgage debt under California law. There is no basis for such a distinction in the broad language of the statute and Regulations. Moreover when viewed from the practical standpoint, the economic effect upon the taxpayer's property is the same regardless of whether he has assumed the mortgage. It should also be noted that in either case, the taxpayer is entitled to use as a basis for depreciation the full amount of the property which means that he can include the

amount of the mortgage. Thus the Tax Court was in error in treating taxpayer's property as equalling only his equity therein. Such a definition of property has not only been repudiated in cases involving condemnation awards but also by the Supreme Court in *Crane v. Commissioner*, 331 U.S. 1, where it was held, in determining the amount of gain realized on an ordinary sale of mortgaged property, that the "property" was not to be diminished by the amount of an unassumed mortgage.

The Commissioner's determination is also supported by the Congressional Committee reports which discuss the statutory provision applicable here. In objecting to that determination, the taxpayer has relied primarily on a decision of this Court which involves depreciation claimed by a lessor on a building erected by the lessee under a 99 year lease. As this Court properly held, the taxpayer in that case had no wasting asset and could not show the required economic loss but in reaching its conclusion, this Court recognized that the facts there were distinguishable from those in the *Crane* case, and indicated that the term "property" may be given the definition for which we contend here.

ARGUMENT

The Tax Court Erred in Failing to Hold That The Taxpayer Realized Taxable Gain During The Taxable Year From The Condemnation Award

It is admitted that the Elk Metropole Hotel, which taxpayer purchased in 1945, was converted as a result of condemnation proceedings in 1949 into money in excess of his adjusted cost basis. Thus taxable gain

was necessarily realized by the taxpayer at that time unless the transaction falls within the non-recognition provisions of Section 112(f) of the Internal Revenue Code of 1939, Appendix A, *infra*, which are an exception to the general rule in providing that no gain shall be recognized if the condemned property is converted into money which is—

forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, * * *. If any part of the money is not so expended, the gain, if any, shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain).

We submit that the purpose of Section 112(f) is to defer, not to exempt, gain realized involuntarily by such events as condemnation proceedings and then only when the indicated statutory requirements have been fully met, but as we shall show, the requirements have not been met in this case and the Tax Court's decision is wrong.

A. The Tax Court's decision is contrary to the established administrative and judicial construction of Code Section 112(f)

The record shows that under the condemnation proceedings, the State of California paid \$207,323.34

for the taxpayer's hotel but in acquiring suitable replacement property (i.e., the Sherwood Apartment Hotel) the taxpayer spent only \$186,125. (R. 7-8, 24-25.) Thus it follows, as the Commissioner determined, that since, in the language of Section 112(f), "part of the money" (i.e., the difference between the two amounts just referred to or \$21,198.34) was "not so expended, the gain" (which is admitted to be \$125,723.34 (R. 9)) "shall be recognized to the extent of the money * * * not so expended * * *".

This is in accord with the long standing administrative construction of the statute embodied in Treasury Regulations. Section 29.112(f)-1 of Regulations 111 provides (Appendix A, *infra*) :

If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments * * *) and mortgages against the property and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. * * *

These Regulations, promulgated under the specific statutory authority found in Section 112(f) have been in force for nearly 24 years¹ and are entitled, by

¹ The provision first appeared in Art. 112(f)-1, Treasury Regulations 86, promulgated under the Revenue Act of 1934. The Regulations were preceded by five years by a similar administrative interpretation by the Bureau of Internal Revenue. See G.C.M. 5302, VIII-1 Cum. Bull. 197 (1929), ruling that "money" received in payment for property taken by condemnation proceeding includes, under the antecedent of Section 112(f), in the Revenue Act of 1924, the amount deducted from the award to pay an indebtedness to the Government.

virtue of the successive reenactments of Section 112 (f) without change, to be regarded as law. Basically, the reason for this interpretation of the statute lies in the requirement that the money into which the property is converted be expended for the statutory purposes. Thus the Regulations also provide (Appendix A, *infra*) :

In order to avail himself of the benefits of section 112(f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. * * *

Obviously, where a portion of the money into which the property is converted is used to discharge a mortgage indebtedness on such property it is not used in the acquisition of other similar property.

The courts have expressly so held. *Commissioner v. Fortee*, 211 F. 2d 915 (C.A. 2d), certiorari denied, 348 U.S. 826; *Ovider Realty Co. v. Commissioner*, 193 F. 2d 266 (C.A. 4th); *Kennebec Box and Lumber Co. v. Commissioner*, 168 F. 2d 646 (C.A. 1st). The reasoning of the court in the *Kennebec* case applies directly to the facts here. The court said (p. 648) :

The payment, from the insurance proceeds, of the mortgage and the use of part of the fund for taxpayer's general business purposes can hardly

be regarded as temporary investments of portions of this fund. These payments were not "investments" at all in any normal sense of that word; they were, on the contrary, final and irrevocable expenditures of this money for purposes utterly foreign to the acquisition of property similar to, or related in use to, the property destroyed.

The tracing provisions of the Regulations, which make explicit what is inherent in the language of the statute, have been sustained in numerous cases in addition to those cited above. See *Vim Securities Corp. v. Commissioner*, 130 F. 2d 106, 109 (C.A. 2d), certiorari denied, 317 U.S. 686; *Commissioner v. Flushingside Realty Co.*, 149 F. 2d 572 (C.A. 2d), certiorari denied, 326 U.S. 754; *Twinboro Corp. v. Commissioner*, 149 F. 2d 574 (C.A. 2d), certiorari denied, 326 U.S. 754; *Winter Realty & Const. Co. v. Commissioner*, 149 F. 2d 567 (C.A. 2d), certiorari denied, 326 U.S. 754.

Both the taxpayer and the Tax Court seek to avoid the implication of these decisions and the Regulations by suggesting that they apply properly only to mortgages which have been assumed by a taxpayer and are his personal obligation. But this distinction has no support in the broad language of the Code section or the Regulations nor can it be justified by the alleged practical difference between the taxpayer's personal obligation with respect to the mortgage debt in the one case and the mere economic burden on the property in the other. In both instances a condemnation award may be distributed partially in payment of the mortgage without regard to the taxpayer's wishes. In both cases the economic effect *upon the taxpayer's*

“*property*” is the same and the taxpayer realizes his admitted gain in the most concrete economic fashion, namely, by the conversion of his property into money. In neither is there any reason for postponement of the tax on such gain.

Moreover, even considered in purely practical terms, there is no significant difference. Normally, the same price is paid for property whether the mortgage is assumed or not, especially where, as in the instant case, the value of the property exceeds the amount of the mortgage. In both cases it will be the taxpayer who alone will gain by the increase in the market value of the property and its conversion into money. Furthermore, whether assumed by him or not, if he wishes to avoid foreclosure, the taxpayer must meet the periodic payments on the mortgage. Similarly in both cases, if the taxpayer wishes to rid his property of the burden of the mortgage or avoid sacrificing his property should the market fall, he must see to it that the mortgage is satisfied. An even more important consideration is that in either case the taxpayer, as we will develop in greater detail elsewhere in this brief, is entitled to depreciation on the full amount of his basis, which in each instance will include the value of the mortgage.²

The Tax Court’s basic error stems from its analysis of the transaction here in such a way as to underestimate the amount of money for which the tax-

² Here, the taxpayer in slightly fore than four years had already taken depreciation on the hotel in the amount of \$8,000, as compared with his original cash investment of \$19,600. (R. 9.)

payer's condemned property was converted. In other words, it was the Tax Court's position that the taxpayer's "property" was converted for the sum of \$149,750.71 (i.e., the difference between the sales price and the amount due on the mortgage when the condemnation occurred.) Obviously this conclusion was based on the assumption that the term "property" as used in Section 112(f) means only the taxpayer's equity in the hotel, and that, as the Tax Court pointed out (R. 11), was also the basis for its decision (19 T.C. 99) in the case of *Fortee Properties, supra*, but it was overruled by the Second Circuit. Since the latter's opinion gives an excellent explanation of Section 112(f) and the facts there are very similar to those here, we take the liberty of quoting from it at length. The court there said (p. 916):

The tacit assumption essential to the court's decision is that the word "property" in § 112(f) of the Internal Revenue Code means no more than the taxpayer's equitable interest in the land and the buildings. We disagree. In our view, the decision here should be governed by the rationale of *Crane v. Commissioner*, 331 U.S. 11, interpreting the meaning of "property" under § 113 of the Internal Revenue Code, 26 U.S.C.A. § 113. The *Crane* case involved the computation of tax gain on the sale of depreciable property subject to a non-assumed mortgage. The Supreme Court held the value of the mortgage must be included in determining the base and the amount realized on the sale. *The decision, distinguishing the words "property" and "equity", reasoned that "property" could not be restricted to mean merely the owner's rights over and above encumbrances.*

While the *Crane* case can literally be distinguished as involving a different section and a different type of transaction, we think both the reasoning and spirit of the opinion are applicable here. The basis of the taxpayer's argument here is that, since he was not personally liable on the mortgage, he received no benefit and, hence, no gain on the satisfaction of the mortgage by payment to the mortgagee. This contention was rejected in the *Crane* case as to a transfer of property subject to a non-assumed mortgage. There the Court said that one "not personally liable on the debt, who sells the property subject to the mortgage and for an additional consideration, realizes benefit in the amount of the mortgage * * *." *Similarly, satisfaction of a non-assumed mortgage, by payment to the mortgagee, benefits taxpayer in the case at bar. In practical terms, for the purpose of protecting his property from foreclosure, where the value of the property is greater than the amount of the mortgage, the taxpayer-mortgagor has to treat the obligations of a non-assumed mortgage as if they were his personal obligations. Payments to the mortgagee relieved the owner of this necessity. (Italics supplied.)*

Crane v. Commissioner, 331 U.S. 1, to which the Second Circuit referred, required a determination of the gain "realized" under 1939 Code Section 111(a) and (b) (Appendix A, *infra*) from the "sale or other disposition of property" which the taxpayer inherited, subject to a mortgage. This, in turn, required a determination of the unadjusted basis of the property under Code Section 113(a) (5). (Appendix A, *infra*.) Both uses of the term "property," the Supreme Court

held, meant the owner's legal rights in the land and buildings sold, undiminished by the mortgage, and not the taxpayer's "equity" in them. Specifically the Supreme Court held (1) that the word "property" should be interpreted in its ordinary every day sense unless there are strong countervailing considerations which would support a different contention (331 U.S. p. 6); (2) that in other parts of the Code Congress has not confused the use of the words "property" and "equity" or made them interchangeable (p. 8); (3) that the word "property" should be construed so as to make such construction consistent with the depreciation and collateral basis adjustment sections (pp. 9-10) and (4) that in construing the "amount realized" and the word "property" it is immaterial whether the seller is or is not personally liable on the mortgage (p. 13).

Each of these considerations is pertinent to this case and the Tax Court's attempt to distinguish them falls far short of the mark. The word "property" in Section 112(f) was used in the same ordinary, everyday sense as was used in Sections 111 and 113. Here, just as in the *Crane* case, the functional relationship between Section 112(f) and the depreciation sections (1939 Code Sections 23(l) and (n) and 114(a)) provides additional support for our views. Under these sections, the basis for depreciation is the basis provided in Section 113(b) for the purpose of determining gain upon the sale of the property, which, in turn, is the Section 113(a) basis adjusted for depreciation. The *Crane* decision conclusively holds (1) that the unadjusted basis under Section 113(a) is the

cost³ of the property *undiminished by the amount of a mortgage*, whether or not the mortgage is personally assumed by the owner of the property and (2) the depreciation allowance is computed on the full amount of this basis. (We do not believe this is open to argument or that the taxpayer will contest it. Indeed, as the record shows (R. 8-9) depreciation here was taken by the taxpayer in four years in the amount of \$8,000 as compared with the taxpayer's original cash investment of \$19,600.) Thus, for depreciation purposes and for the purpose of computing gain or loss on a sale, the mortgage will be included in the taxpayer's "basis" and in any "amount realized."

Since the Tax Court interprets the term "property" in Section 112(f) as including the mortgage in cases where the mortgage debt has been assumed by the taxpayer, it is difficult to see how it can insist that the term "property" be limited to "equity" where the mortgage has not been assumed. Indeed, it must be recognized that in this sense the Tax Court is reverting to its *Crane* decision (3 T.C. 585) which the Supreme Court ultimately rejected when it said (331 U.S., p. 14) :

* * * we think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage

³ More accurately, since the *Crane* case involved property acquired by bequest, the holding therein was that the basis of such property was its fair market value (under Section 113(a)(5)) rather than cost. However, the *Crane* rule applies with equal force to purchased property. *Blackstone Theatre Co. v. Commissioner*, 12 T.C. 801.

as well as the boot. If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage—it may make a difference to the purchaser and to the mortgagee, but not to the mortgagor. Or put in another way, *we are not more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfer subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another. [Italics supplied.]*

We submit that the logic of the observations just quoted demonstrates beyond question the lack of merit in the Tax Court's view that the only "property" of the taxpayer which was converted amounted to \$149,750.71.

B. The Legislative history of Section 112(f) supports the Commissioner's determination

The Tax Court stated (R. 13) that, in deciding that no taxable gain had been realized as a result of the condemnation award, it had not overlooked statements made by the Congressional Committees in connection with Sections of the Act of October 31, 1951, c. 661, 65 Stat. 733, which amended Section 112(f)

prospectively. But we submit that the Tax Court failed to give full meaning to those reports inasmuch as they support our position here. In discussing the proposed changes in Section 112(f) both the House Ways and Means Committee and the Senate Finance Committee stated in identical language (H. Rep. No. 798, 82d Cong., 1st Sess., pp. 1-2; and S. Rep. No. 1052, 82d Cong., 1st Sess., pp. 1-2) that:

While section 112(f) of the code now operates in the majority of cases to relieve taxpayers from the payment of tax upon gain where property has been involuntarily converted, the requirements of this provision have operated to deny relief in some cases where your committee believes that relief should be granted. No relief is accorded under existing law where, before receipt of the proceeds for the converted property, the taxpayer purchases replacement property. Relief is denied in these anticipatory replacement cases since the benefits of section 112(f) are limited to those cases in which the proceeds from the converted property can be directly traced into the subsequently acquired property. A problem also arises under the present law where the taxpayer uses a part of the proceeds from the converted property to pay off indebtedness on the converted property. In such a case the taxpayer is denied the benefits of section 112(f), *that is the taxpayer must pay a tax on any gain from the converted property up to the amount of the proceeds which are used in liquidation of indebtedness on the converted property, even though he also fully replaces the converted property, since the amount used to pay off the indebtedness cannot be directly traced into the replacement property.* (Italics supplied.)

From the above excerpt, it is evident that Congress did not draw any distinction between the payment of mortgage debts which have been assumed and those which have not been assumed by the taxpayer. Thus these Committee reports indicate that Congress intended to approve the Commissioner's interpretation of Section 112(f) and to make it applicable as to all transactions occurring before December 31, 1950. The Tax Court's reason for holding otherwise, as we have pointed out, was that the mortgage here had not been assumed by the taxpayer but as we have already shown under subheading A, *supra*, the fallacy in this approach we believe it unnecessary to discuss this point further.

However, it should be noted here that in support of its interpretation of the Congressional reports the Tax Court cited *Kennebec Box & Lumber Co. v. Commissioner, supra*, and *Ovider Realty Co. v. Commissioner, supra*. In neither of these cases was it stated, as the Tax Court did here, that a distinction should be made between mortgages which are assumed and those which are not assumed by the taxpayer. Indeed the opinions in those cases do not indicate specifically that the mortgages there had been assumed by the taxpayers. However, even if they are so construed, the principle announced therein was stated in such general language that it is clearly applicable here and does not support the Tax Court's decision. This is shown by the *Ovider Realty Co.* case in which the Fourth Circuit said (p. 269):

And it has been held that the gain is taxable when, as in the pending case, the insurance

money is used to pay a mortgage debt on the destroyed property or to pay a debt owing by the taxpayer to a bank, even though the destroyed property is subsequently restored and the taxpayer's financial ability to restore it is enhanced by the receipt of the proceeds of the insurance.

* * * *

Then, after citing most of the cases which we have cited herein, the Fourth Circuit pointed out that, "This line of authority" (p. 269) was recently recognized by the Congressional reports, which we have also referred to as supporting our contention here.

C. The contention of the taxpayer is not supported by the decision of this Court on which he has relied

In the Tax Court, the taxpayer relied primarily on *Commissioner v. Moore*, 207 F. 2d 265 (C.A. 9th), particularly this Court's statement where, in referring to the word "property" as used in 1939 Code Section 113(a) (5), it said (p. 268) :

But "such property" is not the steel frame, brick and terra cotta loft and store building on the corner of Figueroa, Seventh and Flower Streets in the City of Los Angeles,—it is the taxpayer's *interest* in that property. And her interest is a limited one, not only because it is a fractional part, but also because it is subject to the lease. As the Tax Court said, dealing with another point in this case: "What petitioner inherited from her mother was an undivided half interest in the land under the Barker Bros. building *and a reversionary interest in the building.*" (Italics supplied.)

Taxpayer has argued and doubtless will continue to argue that such statement indicates the correctness of his major contention, namely, that the several properties of the mortgagor (i.e., the taxpayer) and of the beneficiary or mortgagee were severally converted into money pursuant to the condemnation proceeding, and that the former received only \$149,750.71 for his property and reinvested all of it.⁴ We do not, of course, agree.

Obviously this Court's statement in the *Moore* case must be considered in the light of the question and facts involved there. In that case taxpayer and her mother owned land which they leased for 99 years to a company which agreed to erect a building thereon. When the mother died some years later, her interest in such property passed to the taxpayer who, in subsequent years, claimed that she was entitled to take deductions on account of depreciation attributable to a one half interest in the building (i.e., the interest inherited from her mother). These were allowed by the Tax Court but this Court reversed its decision. In doing so, this Court said that although taxpayer might have acquired a basis for depreciation under Section 113(a)(5), she did not inherit an interest in a wasting asset. In other words what she got was her mother's reversionary interest in a building which would have no value after 99 years, and her

⁴ Taxpayer has also argued that because of the effect of California law, this case is distinguishable from the *Fortee* case, *supra*; and the Tax Court also discussed California law. (R. 15-16.) But we think there is no material distinction in the two cases and that what we have said under subheading A answers this contention.

mother's interest in the ground rentals which would not be affected in any way by the deterioration of the building. But depreciation deductions were allowed to the lessee over the life of the building. In this connection this Court discussed *Crane v. Commissioner, supra*, which the Tax Court refused to follow here. It said (p. 272) :

The circumstances just mentioned disclose one reason why *Crane v. Commissioner*, 331 U.S. 1, * * * upon which taxpayer relies, does not support the Tax Court's decision on this point. There the Supreme Court held that one who inherited an apartment house worth \$262,000, subject to a mortgage of \$262,000, was chargeable with an amount of gain on resale which was arrived at on the assumption that the mortgagor could take depreciation on the value of the building, notwithstanding her equity was zero. *But there, as the Court was careful to point out, the mortgagor remained in possession, the mortgagee could not take depreciation, and unless the mortgagor could take it, the effect would be to "deny deductions altogether."* Here, to disregard taxpayer's limited interest, and permit her to take depreciation on the full value of the building, while lessee is properly claiming deductions based on the same values, would result in having deductions taken on the same building's depreciation twice. (Italics supplied.)

We submit that in making the above statement this Court was in effect announcing that a taxpayer who owns and is in possession of mortgaged property (regardless of whether he has assumed the mortgage) is to be treated as the owner of the entire property

and can deduct the entire amount allowable by statute for deterioration of the property rather than the portion which might be assigned to his equity therein. Thus it is evident that the *Moore* case does not attempt to limit the word "property" as the Tax Court has done in this case and does not preclude the adoption of the Commissioner's interpretation of Section 112(f). Moreover it did not involve a mortgage debt.

CONCLUSION

The decision of the Tax Court is erroneous and should be reversed.

Respectfully submitted,

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May , 1958

APPENDIX A

Internal Revenue Code of 1939:

SEC. 111. DETERMINATION OF AMOUNT OF, AND
RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money received).

* * * *

(26 U.S.C. 1952 ed., Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * *

(f) [as amended by Sec. 151(d) and (e) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat of imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the ac-

quisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain shall be recognized, but loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain).

* * * *

(26 U.S.C. 1952 ed., Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * *

(5) *Property transmitted at death.*—If the property was acquired by bequest, devise, or inheritance, or by the decedent, the basis shall be the fair market value of such property at the time of such acquisition.

* * *

* * * *

(9) *Involuntary Conversion.*—If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion, described in section 112(f) (1) or (2), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable

to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 113.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.112(f)-1. *Reinvestment of Proceeds of Involuntary Conversion*.—Upon the involuntary conversion of property described in section 112 (f), no gain is recognized if the provisions of that section are complied with. If any part of the money received as a result of such an involuntary conversion is not expended in the manner provided in section 112(f), the gain, if any, is recognized to the extent of the money which is not so extended. * * *

* * * *

In order to avail himself of the benefits of section 112(f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property con-

verted. The benefits of section 112(f) cannot be extended to a taxpayer who does not purchase other property similar or related in service or use, notwithstanding the fact that there was no other such property available for purchase.

If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

* * * *

APPENDIX B

Table of Exhibits pursuant to Rule 18(2)(F) as amended.

<u>Exhibits</u>	<u>Set forth in printed record</u>	<u>Identified, offered and received</u>
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5-E	R. 32 - 33	R. 24
6-F	R. 35	R. 24

No. 15888

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

FRANK W. BABCOCK,

Respondent.

RESPONDENT'S BRIEF.

AUSTIN CLAPP,

1780 Portola Road,
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Attorney for Respondent.

FILE

JUN - 6 1958

PAUL P. O'BRIEN,

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RESPONDENT'S BRIEF.

Statement.

Respondent does not quarrel with the Statement of Petitioner except insofar as it says that the taxpayer executed a *mortgage* and that the State, in the condemnation proceedings paid certain moneys to the *mortgagee*. [R. 3.]

In fact, as shown by the stipulation of facts [R. 23, par. 5], Exhibits 4-D [R. 27, par. 3] and 5-E [R. 33, par. 3] the document executed was a purchase money trust deed. The Tax Court recognized this fact [Opinion, R. 7, second par.] but chose to rest its decision upon grounds unaffected by the distinction between a California purchase money trust deed and a mortgage. As we shall develop, California property law is such as to make it important that taxpayer executed a purchase money trust deed.

Question Presented.

Whether or not the interest of a California Trustor in real property as to which a purchase money trust deed was executed is the "property" which was "converted into money" in a condemnation proceeding so that where all of the money into which it was converted was reinvested in property "similar or related in use or service" no gain on an involuntary conversion should have been recognized and no deduction or adjustment should have been made as a result thereof to an established net operating loss for the year following the involuntary conversion?

Statement of Points to Be Urged.

The decision of the Tax Court was and is correct.

Interests of the trustor and of the beneficiary in the real property involved in the involuntary conversation were several interests in real estate. Each of the several interests was converted into money. All of the money into which the trustor's (Respondent's) property was converted was reinvested in property similar or related in use or service to the property converted. No gain should have been recognized by the Commissioner and no adjustment should have been made to Petitioner's net operating loss in the ensuing year as the result of this transaction.

C. I. R. v. Fortee Properties, Inc. (C. A. 2), 211 F. 2d 915, was wrongly decided and is not controlling or persuasive.

ARGUMENT.

A. The Interests of Trustor and Beneficiary in the Real Property Involved Were Separate Interests in Real Estate and Were Separately Converted Into Money.

Under the law of the State of California trustor and beneficiary in a transaction involving a conveyance of land and the co-terminous execution of a note and purchase money trust deed are co-owners of interests in real estate.

“ . . . the seller who takes back only a note secured by a trust deed has nothing to which he can resort but the land *and in a real sense has converted his entire ownership into a lesser interest in the real estate*. The conveyance to the buyer and the purchase money trust deed cannot be divorced; they come into being simultaneously and must be viewed realistically as a single transaction.”

Moore's Estate, 135 Cal. App. 2d 122, 286 P. 2d 939, 944.

The position of trustor and beneficiary is thus analogous to that of tenants in common in real property whose several interests may be, in a condemnation proceeding, “property” which is “converted into money.” (I. R. C., Sec. 112(f)(2), 26 U. S. C. (1952 Ed.), Sec. 112(f)(2).)

What does the interest of the trustor in such a transaction consist of? He has received, and has conveyed to the trustee the legal title to the property; he has the right of possession, the right to receive and retain the rents, issues and profits, and the right either to complete the purchase or to abandon the transaction without personal liability for any balance of purchase price.

We concede that depreciation allowances are based upon the cost of the property, undiminished by the amount of unpaid purchase price, whether secured by mortgage or otherwise. This is done because the statute says it shall be done. (I. R. C., Sec. 113(a); 26 U. S. C. (1952 Ed.), Sec. 113(a).) But the *cost* of the trustor's limited interest is the full purchase price to be paid if he exercises his right to complete the purchase, not the down payment he may, or may not make. Hence there is no incongruity in the trustor's having taken a depreciation allowance relatively large in comparison to his down payment.

This Court has recognized that the word "property" as used in the Internal Revenue Code, may, depending upon the circumstances of the case, comprise less than complete legal and equitable title. See *C. I. R. v. Moore* (C. A. 9), 207 F. 2d 265, at 268, column 2, where the Court said:

"But 'such property' is not the steel frame, brick and terra cotta loft and store building on the corner of Figueroa, Seventh and Flower Streets in the City of Los Angeles,—it is the taxpayer's interest in that property. And her interest is a limited one, not only because it is a fractional part, but also because it is subject to the lease . . ."

This Court has, as did the California court in *Moore's Estate, supra*, recognized the fact that a trust deed beneficiary has, under California law, a proprietary interest in real property which interest may be considered and determined in a condemnation action.

Thibodo v. United States (C. A. 9), 187 F. 2d 249, 256;

Bullen v. De Bretteville (C. A. 9), 239 F. 2d 824, 830.

Viewed in the light of these principles the separate properties of trustor (Respondent) and of the beneficiary were each, severally converted into money in the condemnation proceedings. Respondent received \$149,750.71 for his "property" and reinvested all of it in property similar or related in use or service and no gain should have been recognized. The decision of the Tax Court in this case was correct and should be affirmed.

B. *C. I. R. v. Fortee Properties, Inc.* (C. A. 2), 211 F. 2d 915, cert. den. 348 U. S. 826, 75 S. Ct. 43, Was Wrongly Decided by the Second Circuit Court of Appeals.

We think that the Second Circuit was in error in considering that the *Fortee* case was governed by *Commissioner v. Crane*, 331 U. S. 1.

All that was involved in *Crane* was a determination that, under the circumstances of the case, in order to arrive at the taxpayer's true capital gain, it was desirable to treat the principal of the unassumed mortgage as so much cash received on the sale. In substance the decision only amounts to saying that between the acquisition and sale of the property the taxpayer's capital account had increased in an amount equal to the depreciation taken by the taxpayer during her ownership plus the \$2,500.00 which she received at the time the property was sold.

The real question involved in such cases is: "What was the economic gain realized by the taxpayer?" This is illustrated by *Woodsam Associates Inc.*, 16 T. C. 649, aff'd 198 F. 2d 357, where an identical result is reached either by treating the mortgages as cash received or by

analyzing its capital account. The following tables show the two types of computation:

Commissioner's Computation

Mortgage in 1943		\$381,000.00
Less: Adjusted basis		
Original Cost	\$296,400.00	
Improvements	1,541.90	
Depreciation	(63,000.00)	234,941.90
		<hr/>
Gain		\$146,058.10

Analysis of Capital Account

Money derived from loans secured by the property during ownership	\$212,500.00
Less: Principal of loans repaid	26,500.00
	<hr/>
Net increase in cash position from loans	186,000.00
Return of cash down payment and cost of improvements	102,941.90
	<hr/>
Overall increase in cash position	83,058.10
Capital returned by way of allowance for depreciation	63,000.00
	<hr/>
Gain	\$146,058.10

Similarly in the case at bar the gain resulting from the conversion is the same whichever method is used.

(a) Sale Price, including trust deed balance, <i>arguendo</i> ,	\$207,323.34
Less: Adjusted Basis	
Original Cost	\$89,600.00
Depreciation	(8,000.00)
	<hr/>
Gain	\$125,723.34

(b) Cash received in condemnation	\$149,750.71
Less: Principal of purchase price paid	12,427.37
	<hr/>
	137,323.34
Return of cash down payment	19,600.00
	<hr/>
	117,723.34
Capital returned by way of depreciation allowance	8,000.00
	<hr/>
Gain	\$125,723.34

Thus in the case at bar we see that it is unnecessary to consider the unpaid balance of the trust deed as cash received in order to determine "the economic gain realized by the taxpayer." (*Woodsam, supra*, p. 655.)

Before analyzing the effect of *Internal Revenue Code*, Section 112(f)(2), upon the transaction in the case at bar it is well to point out that Section 111 relating to realization of gain and Section 112 do not always run hand in hand. In other words, if there is no gain under Section 111 as the result of an involuntary conversion, then it is immaterial how much cash was received or what was done with it. The mere fact, therefore, that it is convenient to include a mortgage debt as cash in the determination of gain does not require that the mortgage be regarded as cash for all purposes.

What is the real purpose of *Internal Revenue Code*, Section 112(f)(2)? It is to make sure, as a condition of non-recognition of gain, that a taxpayer's entire investment in the converted property, including his eco-

conomic gain, is transferred into property similar or related in service or use to the property converted. In the case at bar this result has been accomplished:

Down payment	\$ 19,600.00	
Principal payments	12,427.37	
	<hr/>	
	32,027.37	
Less: Capital returned by way of depreciation	8,000.00	Amount re-
	<hr/>	invested
	24,027.37	in similar
Gain	125,723.34	property
	<hr/>	<hr/>
Capital investment plus gain	\$149,750.71	\$149,750.71
	<hr/>	<hr/>

There can be cases, similar to *Woodsam, supra*, in which it would be necessary or desirable to treat the amount of a mortgage as cash received in order to arrive at a proper result. For instance, suppose that property fully paid for and having a market value of \$207,000.00 and an adjusted basis of \$82,000.00 has been mortgaged to secure payment of a cash loan of \$57,000.00 the proceeds of which have been received by the taxpayer. The property is then condemned, and \$207,000.00 paid, \$150,000.00 to the taxpayer and \$57,000.00 to the mortgagee. In such a case the entire capital investment and gain has not been reinvested if only the \$15,000.00 cash received from the condemnor is reinvested.

The same would be true if the mortgagor were personally liable and his assets were freed to the extent of \$57,000.00 by the payment of the mortgage in the condemnation proceedings.

In the case at bar the taxpayer was not personally liable for the balance unpaid under the trust deed.

Cal. Code Civ. Proc., Secs. 580b and 580d.

Hence, no assets were freed by the payment of the trust deed balance in the condemnation proceedings, and no money or property or value was received by the taxpayer other than the sum of \$149,750.71, all of which was reinvested in similar property.

See: *Harper v. Heizer*, 103 Cal. App. 2d 388 at 390, in which appellant claimed that she had contributed value by signing a purchase money trust deed. *Held*: To the contrary; she suffered no detriment by executing the trust deed.

The whole purpose of *Internal Revenue Code* Section 112(f)(2) is to prevent the taxpayer from being required to pay a tax with respect to a capital gain which he has not sought, and may actively resent, which has been forced upon him by the irresistible power of a governmental agency, unless he chooses voluntarily not to re-establish his position. In cases such as *Fortee*, and the case at bar, the taxpayer cannot reinvest money that he does not and cannot receive.

In *Fortee*, the Second Circuit Court, to try to avoid the logic of the argument that since the taxpayer was not personally liable, no assets were freed by the satisfaction of the mortgage, and therefore no gain was realized, forced the issue by saying that as a practical matter

“ . . . the taxpayer-mortgagor has to treat the obligations of a non-assumed mortgage as if they were his personal obligations. Payment to the mortgagee relieved the owner of this necessity.”

This attempted justification was forced only because of a felt necessity to carry over into *Internal Revenue Code*, Section 112(f), a concept, useful but not necessary, used in determining the existence of a capital gain under *Internal Revenue Code*, Section 111.

On the side of the taxpayer, using the Second Circuit's approach, we might well force the issue the opposite way by saying as a practical matter that ". . . the taxpayer-mortgagor has to treat the money actually received by him in the condemnation proceeding as *all* of the money available for reinvestment." In other words, how can a taxpayer invest money which he does not receive or control? And, is Section 112(f)(2) to be regarded as a device to add additional financial burdens upon property owners who have not fully paid for their properties while those who have fully paid, and who are financially better off, can avoid the impact of the tax entirely?

C. The Tax Court's Decision Is Not Contrary to the Cases Cited by the Commissioner nor Is It Contrary to the Regulations and Interpretations of the Commissioner.

In all of the cases cited by the Commissioner, except *Fortee*, distinguished above, the taxpayer actually received or had some control over the moneys which eventually were used for something other than reinvestment, or alternatively, by means of loans on the property while it was owned by him money were derived and spent for purposes other than reinvestment. We do not quarrel with the result in any of these cases except *Fortee*.

We think that it is this sort of thing that was contemplated by the Commissioner's regulations and inter-

pretations and not the situation in the case at bar for, as the Tax Court said [R. 12]:

“ . . . If his (the Commissioner’s) regulation is intended to cover a case like this one in which the petitioner was not personally liable for the mortgages, then to that extent the regulation is invalid because it frustrates rather than promotes the intention of Congress.”

Conclusion.

In conclusion, we see that the petitioner’s several interest in real estate was converted into money, all of which was reinvested in similar property, and, in any event, the purpose for which *Internal Revenue Code* Section 112(f)(2) was enacted has been fully satisfied, regardless of which approach to the problem is used. The decision of the Tax Court in the case at bar was correct and should be affirmed.

Respectfully submitted,

AUSTIN CLAPP,

Attorney for Respondent.

APPENDIX.

Internal Revenue Code of 1939:

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

* * * * *

(26 U. S. C. (1952 Ed.), Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(f) [as amended by Sec. 151(d) and (e) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat of imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or

in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain shall be recognized, but loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain).

* * * * *

(26 U. S. C. (1952 Ed.), Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property*.—The basis of property shall be the cost of such property; except that—

* * * * *

(26 U. S. C. (1952 Ed.), Sec. 113.)

Section 580b, Code of Civil Procedure for the State of California, provides as follows:

“No deficiency judgment shall lie in any event after any sale of real property for failure of the purchaser to complete his contract of sale or under a deed of trust, or mortgage, given to secure payment of the balance of the purchase price of real property.

“Where both a chattel mortgage and a deed of trust or mortgage have been given to secure payment of the balance of the combined purchase price of both real and personal property, no deficiency judgment shall lie at any time under any one thereof.”

Section 580d, Code of Civil Procedure for the State of California, provides in part as follows:

“No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property hereafter executed in any case in which the real property has been sold by the mortgagee or trustee under power of sale contained in such mortgage or deed of trust. * * *”

No. 15890 ✓

United States
Court of Appeals
for the Ninth Circuit

N. GORDON PHILLIPS and LAURETTA M.
PHILLIPS, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of Record

Petition to Review a Decision of The Tax
Court of the United States

FILED

MAY 22 1958

PAUL P. O'BRIEN, CLERK

No. 15890

United States
Court of Appeals
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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Attorney,
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Attorneys for Respondent.

APPEARANCES

For Petitioner:

SIDNEY R. REED,
A. L. BURFORD, JR.

For Respondent:

MARK TOWNSEND.

The Tax Court of the United States

Docket No. 58561

N. GORDON PHILLIPS, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1955

Jun. 21—Petition received and filed. Taxpayer notified. Fee paid.

Jun. 22—Copy of petition served on General Counsel.

Aug. 15—Answer filed by General Counsel.

Aug. 15—Request for hearing in Los Angeles, filed by General Counsel.

Aug. 17—Notice issued placing proceeding on Los Angeles calendar. Service of Answer and request made.

1957

- Apr. 2—Hearing set June 3, 1957—Los Angeles, Calif.
- May 7—Notice of change of beginning date to June 4, 1957, Los Angeles, Calif.
- Jun. 5—Hearing had before Judge Mulroney on the merits. Oral motion of counsel for petitioner to consolidate for hearing, and opinion. No objection by respondent. Granted. Submitted. Stipulation of Facts filed. Briefs due July 22, 1957. Reply briefs due Aug. 21, 1957.
- July 1—Transcript of Hearing—June 5, 1957 filed.
- July 9—Joint motion for extension of time to Aug. 23, 1957 to file brief, filed. Granted 7/9/57. Served 7/10/57.
- Aug. 19—Brief for Respondent filed. Served 8/26/57.
- Aug. 26—Brief for Petitioner filed. Served 8/26/57.
- Sep. 16—Reply Brief for Petitioner filed. Served 10/2/57.
- Oct. 16—Opinion filed—Judge Mulroney—Decision will be entered for respondent. Served 10/16/57.
- Oct. 16—Decision entered. Judge Mulroney. Served 10/18/57.
- Oct. 28—Motion by petitioner for review by Full Court—Denied 11/1/57. Served 11/5/57.

1958

- Jan. 9—Petition for Review by U. S. Court of Appeals, Ninth Circuit, filed by petitioner.

1958

Jan. 9—Affidavit of service by mail, filed.

Jan. 9—Designation of contents of record, with statement of service thereon, filed.

Jan. 16—Appearance of A. L. Burford, Jr., Esq. filed.

Jan. 24—Supplemental Designation of Contents of record on review with proof of service thereon, filed by respondent.

Feb. 6—Agreement to Supplemental designation filed.

The Tax Court of the United States

Docket No. 58562

LAURETTA M. PHILLIPS, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

[Note: Docket Entries in Docket No. 58562 are the same as Docket No. 58561.]

[Title of Tax Court and Docket No. 58561.]

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau symbols Ap:LA:AA-DRR 90-D)

dated April 15, 1955, and as a basis for his proceeding alleges as follows:

1. The petitioner is an individual whose address is 715 North Maple Drive, Beverly Hills, California. The return for the period here involved was filed with the Collector of Internal Revenue for the Sixth District of California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on April 15, 1955.

3. The deficiency as determined by the Commissioner is liability for individual income taxes for the taxable year ended December 31, 1951, in the amount of \$15,525.59. The amount in controversy is \$12,056.00.

4. The determination of taxes set forth in the said notice of deficiency is based upon the following error:

(a) The Commissioner erroneously and improperly included as a capital gain \$48,224.00, representing proceeds from the sale of 320 shares of stock.

5. The facts upon which petitioner relies as a basis of this proceeding are as follows:

(a) Prior to December 27, 1950, the petitioner transferred by written agreement 320 shares of stock of Gordon Oil Company, a California corporation, which petitioner had organized and promoted. The 320 shares of stock were transferred to Goran W. Raichart, who died on December 27, 1950. The consideration of said transfer to Goran W. Raichart was for services rendered to the petitioner in promoting the sale of Gordon Oil Com-

pany stock. At the time petitioner executed the agreement assigning said 320 shares to Goran W. Raichart, said stock and other shares owned by petitioner were in escrow, under orders of the Corporation Commissioner; and therefore, Goran W. Raichart did not get possession of the stock certificate before he died.

(b) Thereafter on January 24, 1951, petitioner sold all of his shares of Gordon Oil Company stock and the 320 shares previously transferred to Goran W. Raichart.

(c) Gordon Oil Company was dissolved in August 1951.

(d) Thereafter a dispute arose between the Estate of Raichart and petitioner over the rights of petitioner and the Estate of Raichart to the said 320 shares of stock. Following a hearing on its merits, the Superior Court of San Diego County, State of California, found that petitioner was a constructive trustee of said 320 shares of stock for the benefit of Raichart, and therefore the monies received for same, \$48,224.00, were received by petitioner for the account of the Estate of Raichart. Petitioner then paid said sum of \$48,224.00, plus interest, to the Estate of Raichart.

(e) The District Court of Appeals, State of California, affirmed the findings and decision of the Superior Court. 120 C.A. 2d. 645.

(f) The Commissioner has erroneously included as a part of petitioner's income the proceeds from the sale of the said 320 shares of stock in the amount of \$48,224.00.

Wherefore, the petitioner prays that this Court may hear the proceeding and determine that there is no deficiency due from petitioner for the year 1951; and for any other and further relief as in the opinion of the Court petitioner is entitled to under the law.

/s/ N. GORDON PHILLIPS.

/s/ SIDNEY R. REED,
Counsel for Petitioner.

Duly Verified.

EXHIBIT "A"

Form 1230 (App.)

U. S. TREASURY DEPARTMENT
Internal Revenue Service
Regional Commissioner
1250 Subway Terminal Building
417 South Hill Street
Los Angeles 13, California

April 15, 1955

In replying refer to Ap:LA:AA-DRR 90-D

Mr. N. Gordon Phillips and
Mrs. Laurretta M. Phillips, Husband and Wife
715 North Maple Drive
Beverly Hills, California

Dear Mr. and Mrs. Phillips:

You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1951 discloses a deficiency or deficiencies of \$15,525.59, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Assistant Regional Commissioner, Appellate, Room 1250, 417 S. Hill St., Los Angeles 13, Calif. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earlier.

Very truly yours,

T. COLEMAN ANDREWS,
Commissioner,

/s/ By G. L. DUCKER,
Associate Chief, Appellate
Division.

Enclosures: Statement, Form 1276 Agreement Form.

STATEMENT

Mr. N. Gordon Phillips and Mrs. Lauretta M. Phillips, Husband and Wife, 715 North Maple Drive, Beverly Hills, California.

Tax Liability for the Taxable Year
Ended December 31, 1951

INCOME TAX

Year	Deficiency
1951	\$15,525.59

In making this determination of your income tax liability careful consideration has been given to the report of examination dated October 27, 1954, to your protest dated December 14, 1954, and to the statements made at the conference held on February 16, 1955.

A copy of this letter and statement has been mailed to your representative, Mr. Sidney R. Reed, 608 South Hill Street, Los Angeles 14, California, in accordance with the authorization contained in the power of attorney executed by you.

ADJUSTMENTS TO NET INCOME

Taxable Year Ended December 31, 1951

Net income as disclosed by return	\$769,714.49
Unallowable deductions and additional income:	
(a) Net capital gain increased	31,051.19
Net income adjusted	<u>\$800,765.68</u>

EXPLANATION OF ADJUSTMENT

(a) In your return for the year 1951 you reported long-term capital gains of \$1,655,191.90 taxable to the extent of 50%, or \$827,595.95. It has been determined, pursuant to the provisions of section 117 of the Internal Revenue Code of 1939 that you realized long-term capital gains of \$1,724,799.59 taxable to the extent of 50%, or \$862,399.80. The following adjustments are being made to the net capital gain as reported:

Net gain from sale of capital assets	
shown on return	\$827,595.95
(1) Increase in net long-term	
capital gain	\$34,803.85
(2) Capital loss carry-over	(3,752.66)
	<u>31,051.19</u>
Net capital gain corrected	<u>\$862,399.80</u>

(1) The increase in long-term capital gain is due to a reduction in the basis of the stock sold, as shown below:

Nelson-Phillips Oil Co.

Cost reported	\$ 37,760.00	
As corrected	31,724.52	\$ 6,035.48

Gordon Oil Co.

Cost reported	\$112,100.00	
As corrected	48,527.79	63,572.21

Total decrease in cost basis	\$ 69,607.69
------------------------------------	--------------

Taxable at 50%	\$ 34,803.85
----------------------	--------------

(2) In the year 1950 you sustained a capital loss in the amount of \$4,752.66, which was limited to \$1,000.00. The balance of \$3,752.66 is allowable as a capital loss carry-over to the year 1951.

COMPUTATION OF TAX

Taxable Year Ended December 31, 1951

Net income	\$800,765.68
Less: Exemptions	2,400.00
Balance subject to tax	\$798,365.68
Joint return— $\frac{1}{2}$ of \$798,365.68	\$399,182.84
Tentative tax	\$338,552.38
Combined normal tax and surtax—multiply by 2	\$677,104.76
Alternative tax	\$429,323.57
Income tax liability	\$429,323.57
Liability disclosed by return, account No. 7-329004	413,797.98
Deficiency of income tax	\$ 15,525.59

COMPUTATION OF ALTERNATIVE TAX

Taxable Year Ended December 31, 1951

Net income	\$800,765.68
Less: Excess of net long-term capital gain over net short-term capital loss	862,399.80
Ordinary net income	\$ 0.00
Partial tax	\$ 0.00
Plus: 50% of gain	429,323.57
Alternative tax	\$429,323.57

Served June 22, 1955.

[Endorsed]: T.C.U.S. Filed June 21, 1955.

[Title of Tax Court and Docket No. 58561.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, John Potts Barnes, Chief Counsel, Internal Revenue Service, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1, 2, 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

4. Denies the allegations of error contained in paragraph 4 of the petition and subparagraph (a) thereof.

5. (a)-(b). Denies the allegations contained in subparagraphs (a) and (b) of paragraph 5 of the petition.

(c) For lack of sufficient information, denies the allegations contained in subparagraph (c) of paragraph 5 of the petition.

(d) Denies the allegations contained in subparagraph (d) of paragraph 5 of the petition.

(e) Admits that the District Court of Appeals, State of California, affirmed the findings and decision of the Superior Court. 120 C.A. 2d. 645.

(f) Denies the allegations contained in subparagraph (f) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation contained in the petition, not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that this appeal be denied and that the respondent's determination be sustained.

/s/ JOHN POTTS BARNES, REM,
Chief Counsel, Internal Revenue
Service.

Of Counsel: Melvin L. Sears, Regional Counsel,
E. C. Crouter, Assistant Regional Counsel, R.
E. Maiden, Jr., Special Assistant to the Re-
gional Counsel, Mark Townsend, Attorney, In-
ternal Revenue Service.

[Endorsed]: T.C.U.S. Filed August 15, 1955.

[Title of Tax Court and Docket No. 58562.]

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau symbols Ap:LA:AA-DRR 90-D) dated April 15, 1955, and as a basis for her proceeding alleges as follows:

1. The petitioner is an individual whose address is 715 North Maple Drive, Beverly Hills, California. The return for the period here involved was filed with the Collector of Internal Revenue for the Sixth District of California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on April 15, 1955.

3. The deficiency as determined by the Commissioner is liability for individual income taxes for the taxable year ended December 31, 1951, in the amount of \$15,525.59. The amount in controversy is \$12,056.00.

4. The determination of taxes set forth in the said notice of deficiency is based upon the following error:

(a) The Commissioner erroneously and improperly included as a capital gain \$48,224.00, representing proceeds from the sale of 320 shares of stock.

5. The facts upon which petitioner relies as a basis of this proceeding are as follows:

(a) The controversy between the petitioner and the Commissioner is caused by virtue of a joint income tax return filed for the taxable year ended December 31, 1951, by petitioner and her husband, N. Gordon Phillips. The subject of the controversy is a business transaction involving the proceeds from the sale of 320 shares of stock of Gordon Oil Company, which transaction was performed by petitioner's husband, N. Gordon Phillips.

(b) Prior to December 27, 1950, the petitioner's husband, N. Gordon Phillips, transferred by written agreement 320 shares of stock of Gordon Oil Company, a California corporation, which petitioner's husband had organized and promoted. The 320 shares of stock were transferred to Goran W. Raichart, who died on December 27, 1950. The

consideration of said transfer to Goran W. Raichart was for services rendered to the petitioner's husband in promoting the sale of Gordon Oil Company stock. At the time petitioner's husband executed the agreement assigning said 320 shares to Goran W. Raichart, said stock and other shares owned by petitioner's husband were in escrow, under orders of the Corporation Commissioner; and therefore, Goran W. Raichart did not get possession of the stock certificate before he died.

(c) Thereafter on January 24, 1951, petitioner's husband sold all of his shares of Gordon Oil Company stock and the 320 shares previously transferred to Goran W. Raichart.

(d) Gordon Oil Company was dissolved in August, 1951.

(e) Thereafter a dispute arose between the Estate of Raichart and petitioner's husband over the rights of petitioner's husband and the Estate of Raichart to the stock. Following a hearing on its merits, the Superior Court of San Diego County, State of California, found that petitioner's husband was a constructive trustee of said 320 shares of stock for the benefit of Raichart, and therefore the monies received for same, \$48,224.00, were received by petitioner's husband for the account of the Estate of Raichart. Petitioner's husband then paid said sum of \$48,224.00, plus interest, to the Estate of Raichart.

(f) The District Court of Appeals, State of Cali-

fornia, affirmed the findings and decision of the Superior Court. 120 C.A. 2d 645.

(g) The Commissioner has erroneously included as a part of petitioner's income the proceeds from the sale of the said 320 shares of stock in the amount of \$48,224.00.

Wherefore, the petitioner prays that this Court may hear the proceeding and determine that there is no deficiency due from petitioner for the year 1951; and for any other and further relief as in the opinion of the Court petitioner is entitled to under the law.

/s/ LAURETTA M. PHILLIPS,

/s/ SIDNEY R. REED,

Counsel for Petitioner.

[Exhibit A—Notice of Deficiency is the same as set out at pages 8-11 of this printed record.]

Duly Verified.

Served June 22, 1955.

[Endorsed]: T.C.U.S. Filed June 21, 1955.

[Title of Tax Court and Docket No. 58562.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, John Potts Barnes, Chief Counsel, Internal Revenue Service, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1, 2, 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

4. Denies the allegations of error contained in paragraph 4 of the petition, and subparagraph (a) thereof.

5. (a) Admits that the controversy between the petitioner and the Commissioner is caused by virtue of a joint income tax return filed for the taxable year ended December 31, 1951, by petitioner and her husband, N. Gordon Phillips. Denies the remaining allegations contained in subparagraph (a) of paragraph 5 of the petition.

(b)-(c). Denies the allegations contained in subparagraphs (b) and (c) of paragraph 5 of the petition.

(d) For lack of sufficient information, denies the allegations contained in subparagraph (d) of paragraph 5 of the petition.

(e) Denies the allegations contained in subparagraph (e) of paragraph 5 of the petition.

(f) Admits that the District Court of Appeals, State of California, affirmed the findings and decision of the Superior Court. 120 C.A. 2d 645.

(g) Denies the allegations contained in subparagraph (g) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation contained in the petition, not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that this appeal be denied

and that the respondent's determination be sustained.

/s/ JOHN POTTS BARNES, REM,
Chief Counsel, Internal Revenue
Service.

Of Counsel: Melvin L. Sears, Regional Counsel,
E. C. Crouter, Assistant Regional Counsel, R.
E. Maiden, Jr., Special Assistant to the Re-
gional Counsel, Mark Townsend, Attorney, In-
ternal Revenue Service.

[Endorsed]: T.C.U.S. Filed August 15, 1955.

The Tax Court of the United States

Docket No. 58561

N. GORDON PHILLIPS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 58562

LAURETTA M. PHILLIPS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

STIPULATION OF FACTS

It is hereby stipulated (without limiting either party in the presentation of any other items of

proof, either related or unrelated to the matter herein referred to) as follows:

1. The petitioners are husband and wife residing in Beverly Hills, California. They filed a joint income tax return for the taxable year ended December 31, 1951 with the Collector of Internal Revenue at Los Angeles, California. Attached hereto and marked Joint Exhibit 1-A is a true copy of such return.

2. Petitioner Laurretta M. Phillips is interested in this case by virtue of the community property laws of California and her liability under the joint income tax return for 1951.

3. Petitioner N. Gordon Phillips, hereinafter called "Petitioner", organized and promoted the Gordon Oil Company, a California corporation, organized on January 30, 1949. For his services and for the transfer of certain leasehold interests, he was to receive one-half ($1\frac{1}{2}$) of the stock of said company. A permit was issued by the Corporation Commissioner of the State of California in March, 1949, authorizing the issuance of 13,000 shares of stock to petitioner and the sale of an additional 13,000 shares at a par value of \$10, and providing that all shares should be held in escrow and that petitioner should receive no dividends on his shares until the purchasers of shares for cash had been reimbursed for the full purchase price.

4. In August, 1949, a written agreement was entered into between petitioner and one Raichart reading as follows:

“San Diego, California

August 18, 1949

“For promotional services rendered by G. W. Raichart I, N. Gordon Phillips, hereby agrees to give when received from escrow, or order of the Corporation Commissioner, and G. W. Raichart hereby agrees to accept as payment in full for his promotional services, a total of 320 shares of capital stock of the Gordon Oil Company when issued to N. Gordon Phillips as authorized under the terms of its permit, with the Corporation Department of the State of California and pursuant to all covenants, conditions and terms of said permit, governing all stock when issued to N. Gordon Phillips.”

“The undersigned hereby certifies that he further agrees to accept and be bound by all the provisions of the order of the Commissioner of Corporations of the State of California, contained in said permit when the stock is issued to

Signed: N. Gordon Phillips

Accepted: G. W. Raichart.”

5. Dr. Raichart died on December 27, 1950. Shortly thereafter, Phillips put through a transaction by which one Kline agreed to purchase all of the stock of the Gordon Oil Company. On March 21, 1951 the petitioner received 11,210 shares out of escrow and on or about the same date sold them to Kline for \$1,689,347.00. In August, 1951 said Gordon Oil Company was dissolved, thereby extinguishing all of its outstanding shares.

6. Petitioner received only 11,210 shares out of escrow because the Corporation Commissioner of California had consented to the following transfers of stock on March 18, 1949 within escrow from Phillips to:

L. Lek	200 shares
Chester B. Nelson	500 shares
Guy B. Davis	10 shares
Francis H. Gregory	540 shares
N. Stokes Rice	540 shares

1790

When the escrow closed, these shares were delivered directly to the named parties.

7. The executrix of the estate of Dr. Raichart brought an action for breach of contract against petitioner, with a second count for conversion, involving the right to 320 shares of corporate stock. In an adversary proceeding, the Superior Court in and for the State of California, County of San Diego, rendered a decision in favor of the plaintiff. Attached hereto and marked Joint Exhibit 2-B is a true copy of the "Findings of Fact and Conclusions of Law" and the "Judgment" of such court. The District Court of Appeals, Fourth District, California, affirmed the judgment of the Superior Court in a decision reported in 120 Cal. App. 2d 645, 261 P 2d 777. Appeal to the Supreme Court of California was denied.

8. Petitioner paid the judgment together with

interest, a total amount of \$56,755.73, in 1953. Attached hereto and marked Joint Exhibit 3-C is a true copy of petitioners' return for the year 1953.

/s/ SIDNEY R. REED,

Counsel for Petitioners.

/s/ NELSON P. ROSE, REM,

Chief Counsel, Internal Revenue Service, Counsel
for Respondent.

[Endorsed]: T.C.U.S. Filed June 4, 1957.

[Title of Tax Court and Docket No. 58561.]

TRANSCRIPT OF PROCEEDINGS

Courtroom of the United States Tax Court, Department 9, Federal Building, Los Angeles, California, Wednesday, June 5, 1957, 10:00 a.m.

The above-entitled matter came on for hearing, pursuant to notice, at 10 a.m.

Before: The Honorable John E. Mulroney.

Appearances: Sidney R. Reed, Room 512, 608 South Hill Street, Los Angeles, California, on behalf of the Petitioner. Mark Townsend, 1135 Subway Terminal Building, Los Angeles, California, on behalf of the Respondent. [1]*

Proceedings

The Clerk: Docket Number 58561, N. Gordon and Laurretta Phillips.

* Page numbers appearing at top of page of Reporter's Transcript of Record.

State your appearances, please.

Mr. Reed: Sidney R. Reed for the Petitioner.

Mr. Townsend: Mark Townsend for the Respondent.

The Court: Come forward on the Phillips case.

Mr. Reed: Does your Honor care for a statement of what our position is?

The Court: Yes, I'd like it, Mr. Reed. First, have you got a stipulation of any of the facts?

Mr. Reed: Yes, we have. They're substantially stipulated, your Honor. I will begin the stipulations with exhibits attached as Nos. 1-A and 2-B.

The Court: Stipulation with Exhibit 1-A and 2-B will be received.

Mr. Reed: There are two cases here, husband and wife cases, and I move that they be consolidated for the hearing.

The Court: The motion will be granted.

Mr. Reed: Your Honor, these cases involve a single issue. The question is whether or not the Petitioners are taxable on the sale of 320 shares of stock of the Gordon Oil Company, which the Courts of California have held he did not own at the time the purported sale took place. In 1949, the Petitioner owned an undivided one-third interest in two [3] mineral leases. He transferred that interest to a new company that he organized known as Gordon Oil Company.

In consideration of the assignment of the leases and the promotion of the company, he was paid 13,000 shares of stock of the Gordon Oil Company. However, the Corporation Commissioner required

the stock to be held in escrow until such time as other stockholders who had paid cash for their stock had received a full return of their purchase price in the form of dividends.

The escrow did not terminate until on or about March of 1951. During the time the stock was held in escrow, the Petitioner had some business dealings with one Richert, and in those dealings he delivered to Richert an agreement dated August 18, 1949. The contents of the agreement are in our stipulation of facts.

The agreement was executed by both the parties, and in it purported to transfer 320 shares of stock from the Petitioner to Richert subject, however, to the escrow terms.

Richert died in December of 1950. In January of 1951, the Petitioner, along with all the other stockholders of Gordon Oil Company, sold their stock to one Kline. The Petitioner had never made an actual delivery of the stock to Richert; during the interval when it was held in escrow with the approval of the Corporation Commissioner, certain of the stock had been transferred to other persons by petitioner, so that [4] when the escrow closed, Petitioner *still* 11,210 shares. Now, that figure included the 320 shares of stock that became the subject of litigation between the Estate of Richert and Petitioner.

Petitioner included in his 1951 Return the entire proceeds from the 11,210 shares of Gordon Oil Company stock.

The Estate of Richert brought a suit for breach

for contract and conversion, alleging that the 320 shares of stock rightfully belonged to Richert. The plaintiff prevailed in that action. It was a hotly contested action; the transcript was 585 pages of testimony. The Petitioner was represented by two eminent lawyers in that contest.

The District Court of Appeals affirmed the findings and conclusions of law of the trial court. A hearing was denied by the Supreme Court.

Thereafter, Petitioner paid a judgment of thirty-six thousand and some-odd dollars to the Estate of Richert in 1953. Now, in 1953, the Petitioner had no income. At no time had they ever received a benefit of that payment of that \$36,000.00. The 1951 return of Petitioner reduced the basis of the stock of the Gordon Oil Company stock, creating thereby a deficiency. The Petitioner did not contest that adjustment. However, the respondent refused to adjust his 1951 liability in accordance with the findings of the California courts, which held Petitioner was not the owner of that stock at the time it was [5] transferred to Richert.

Now, our position in this case is that it has been followed by this Court over a long period of time, namely, that in an adversary litigation proceeding over the division of property, that the Federal Courts and this Court are bound by the findings of fact and conclusions of law of the State Courts. We believe that our position is sound. It is not a case where there is any question about whether or not title passed between them in '49; that's been decided by the courts.

I'd like to introduce into evidence the——

Mr. Townsend: Pardon me, Mr. Reed, that's already in as Exhibit 2.

Mr. Reed: That's right. I forgot.

I'd like to quote from the decision of the trial court in the Richert case:

"It is true that on the 27th day of December, 1950, at the date of the death of said G. W. Richert, the said G. W. Richert was the owner of and entitled to the immediate possession of said 320 shares of common capital stock in the Gordon Oil Company, a California corporation, when released by the Corporation Commissioner in accordance with said escrow, that ever since the death of said G. W. Richert, the owner is entitled to immediate possession of said 320 shares of stock as of January 24, 1951." [6]

Now, your Honor, the reason that a money judgment was paid in this matter was because in August of 1951, the transferee, Kline, caused the Gordon Oil Company to be dissolved. Therefore, the stock was no longer in existence after that. Therefore, the trial court valued the stock at one hundred fifty-two per share, and awarded the plaintiff a judgment in this amount, plus a dividend that had been paid, plus interest on that sum to the date of payment.

I believe that's substantially—that substantially states Petitioner's position in this matter.

Mr. Townsend: Your Honor, I will not review the facts that Mr. Reed has already covered. The deficiency involved is approximately fifteen thou-

sand and some-odd dollars. Mr. Reed has pointed out that a suit was brought in the Superior Court. In that suit, the Petitioner herein took the position that there was never any intention to transfer that stock, that the agreement was a nullity, and the alternative agreement had been rescinded.

It is the Government's position that the Petitioner had a claim of the right to that stock, that he did not agree to turn over any specific 320 shares out of his 11,210, and that he had a right to convey, subject to a suit for breach of contract and conversion, and that since he had a claim of right, he sustained the taxable income on the sale of the stock and then he would be entitled to a deduction in 1953 when [7] he finally paid out the liability.

It's the Respondent's position that the case comes within the *North American Consolidated v. Burnett*, and also the recent *Redkin v. United States*.

I might point out that the stipulation of facts refers to three exhibits, the third exhibit is the 1953 income tax return which we have not as yet been able to secure, that we hope to have before the Court leaves, and we will duly submit it as the third exhibit.

The Court: What year?

Mr. Townsend: 1953.

Mr. Reed requested me to supply that, and I believe it's been his intention to show that benefit was secured by the tax year 1953. The year involved is 1951, your Honor, when the stock was sold.

The Court: Any dispute in fact, gentlemen? Sounds like it's just a legal proposition.

Mr. Townsend: It is primarily a legal proposition, your Honor.

I believe we do have an evidence that will come up as admissibility of certain evidence, and I believe Mr. Reed intends to call Mr. Phillips primarily for background material in the case, but I think that's primarily—I would also like permission, if I may, to withdraw 1-A, which is the income tax return for 1951, and substitute a photostatic [8] copy.

The Court: Yes, that will be done.

Mr. Townsend: Thank you, your Honor.

Mr. Reed: Mr. Phillips?

Whereupon,

N. GORDON PHILLIPS

was called as a witness on behalf of the Petitioners, and having been first duly sworn, testified as follows:

The Clerk: State your name and address for the record.

The Witness: N. Gordon Phillips, 715 North Maple Drive, Beverly Hills.

Direct Examination

Q. (By Mr. Reed): Mr. Phillips, you are the Petitioner in this case? A. Yes.

Q. And Mrs. Phillips is also a Petitioner?

A. That's right.

Q. I show you what purports to be the 1951 re-

(Testimony of N. Gordon Phillips.)

turn of N. Gordon and Laurretta Phillips, and ask you if that's your signature? A. Yes.

Q. This is your 1951 Federal Income Tax Return, is it? A. That's right.

Q. Is this the tax you paid on this return? What is [9] that amount? A. \$413,797.98.

Q. Calling your attention to the schedule attached to your return, entitled "Sale of Capital Assets," what number of Gordon Oil Company shares of stock did you sell?

A. 11,210 shares.

Q. Were those all the shares of stock you received out of escrow? A. Yes.

Q. I believe you were the defendant in the case of Richert vs. Phillips? A. Yes.

Q. What was the holding of that court in regard to 320 shares of the Gordon Oil Company stock?

Mr. Townsend: I believe the decision speaks for itself, and this witness is not involved——

The Court: Of course, the decision is. I presume it's a preliminary or something.

Mr. Reed: Yes, generally.

Q. (By Mr. Reed): Now, how many shares of stock were involved in the Court's ruling?

A. 310—320, pardon me.

Q. 320? A. Yes. [10]

Q. You paid a judgment in accordance with the Court's ruling? A. Yes.

Q. When? A. I forget the exact date.

Q. In 1953, did you have taxable income?

A. No.

(Testimony of N. Gordon Phillips.)

Q. In that year, did you or any—or any other year, get the benefit of any monies paid in accordance with the judgment? A. No.

Cross Examination

Q. (By Mr. Townsend): Mr. Phillips, directing your attention to your 1951 income tax return, Exhibit 1-A, specifically to the schedule showing the sale of capital assets, I notice thereon a heading, "Deposits by other Stockholders, Gordon Oil Company," thirty-two thousand and some-odd dollars, which you have included in your over-all capital gain; could you explain that item?

A. Now, you're talking about which one?

Mr. Reed: Your Honor, I object to that. I don't believe that's an issue before this Court.

The Court: Overruled.

He wants you to show him. [11]

Q. (By Mr. Townsend): This figure here (indicating).

A. Now, you want me to explain what that is, and——

Q. Yes, please.

A. Sorry, I'm afraid I can't answer that. I'd——

Mr. Townsend: If it's possible, we could read the stipulation on that, Mr. Reed.

I believe that amount represents the deposits from the stockholders on shares previously purchased from you to pay off the final amount that they owed you, from other stockholders rather than from Mr. Kline; you so stipulate?

(Testimony of N. Gordon Phillips.)

Mr. Reed: We will so stipulate, yes, sir.

Mr. Townsend: The question was solely for clarification, your Honor.

Q. (By Mr. Townsend): Now, Mr. Phillips, who was your attorney in the state court action?

A. It was Ellison.

Q. Eugene Ellison? A. That's right.

Q. Now, in that state court action, what did you testify with respect to that agreement?

Mr. Reed: I object to what he testified to. Surely there is no materiality in this case; it's a different issue, different parties, and the record of that case is not admissible [12] in this proceeding for any purpose.

The Court: The testimony of conditions under which he claimed it will probably be of interest.

Mr. Reed: He has already answered that question that he did consider it his own stock. The question has been asked and answered.

The Court: I think if he's already testified that he did hold it, he has a claim of right. I didn't know that he had said it quite that plainly.

You might ask him that first, and that will eliminate any testimony.

Q. (By Mr. Townsend): Did you so testify, Mr. Phillips, that——

The Court: No, not that he testified. I mean, how did he hold the stock.

Q. (By Mr. Townsend): Did you hold your stock as your own under a claim at that time?

A. Yes, I did.

(Testimony of N. Gordon Phillips.)

Mr. Reed: Your Honor, I ask that the witness, to come to a conclusion——

The Court: It won't be received as any binding conclusion of the legal proposition of claim of right because I'm sure Mr. Phillips doesn't know that rule of law, just how he claimed ownership at that time. [13]

Mr. Reed: I believe the record should show the Petitioner objected.

Mr. Townsend: I have no further questions.

Mr. Reed: That's all.

If your Honor please, I believe this is one case we can get a decision on now. I believe this case is strictly parallel with the Stein case, and follows a long established rule of this Court that in adversary proceedings in a state court over division of property, or the ownership of the property, that the Commissioner is bound.

Mr. Townsend: Your Honor, I haven't rested my case yet.

Mr. Reed: I'm sorry; excuse me.

Mr. Townsend: There's one point in—one piece of evidence I would like to offer, your Honor.

I asked Mr. Reed to bring down the pleadings that were filed in the Superior Court case of Mr. Phillips. He was unable to bring them in. He assures me we will have them, and can get them in a short time.

My point on introducing the answer filed by the defendant in that case is again his position in that

case as contrary to his position in this case, and I believe it is admissible as an admission and further to show the Government's theory on the case on the claim of right, and Mr. Reed assured me he can get it for me, and I would like to offer that, or at [14] least to secure a ruling from the Court on admissibility of that evidence.

Mr. Reed: If your Honor please, Petitioner would strongly object to the admission of that evidence. It's been ruled on by this Court that the proceedings of a prior case are not admissible as evidence. Here again I must mention that the parties are different and the issue is different.

Naturally, in a complaint and answer, a lot of legalistic language is used, he did or didn't and so forth, and I don't think it proper evidence in this case; I think here we have a very simple question.

In a hotly litigated case, the California courts held that this man did not own the stock, and therefore he, under California law, took it as an involuntary trust deed for the benefit of Richert.

The Court: I think it would be perfectly admissible, Mr. Reed.

We are admitting a judgment in this case, and the pleadings, I think, would also be admissible, and as soon as they are received, I will entertain a motion to admit them, and you can make the objection, but certainly I think they would be admissible.

Is there any more of the record than just that?

Mr. Townsend: Well, I was also going to offer the plaintiff's complaint in the case, your Honor,

to show the [15] type of action that was brought by the plaintiff.

The Court: That's what I mean, the complaint and the answer?

Mr. Townsend: The entire pleadings, yes, sir.

The Court: Perfectly admissible.

It isn't a question of *res adjudicata*, or anything like that as far as the parties are concerned, like we frequently—frequently the parties have to be the same in order to have pleadings of the state court admitted, but here, this action turns on the claim that the Petitioner made, during the year involved, the sale.

Mr. Reed: If your Honor please, in that litigation is a question of who owned that stock on the date of this transfer to Kline. In this, if your Honor please, the Petitioner in this action did not own that stock on the date it was transferred, the court being bound by it. It would appear to me that the record in the prior case would have no bearing.

The Court: All that is going to go to the legal proposition of whether or not he must take this loss in the year in which he pays back. I don't know the answer to that; I have one or two opinions on that involving the claim of right; I have to take the matter under consideration, but as far as the evidence is concerned of the pleadings, and the judgment entered in that case, I certainly think it perfectly admissible.

Mr. Reed: I can have them here. I will take a

cab [16] down to my office, and I can have them in 30 or 40 minutes.

The Court: Is there more?

Mr. Townsend: That's all, your Honor.

The Court: Then, subject to the introduction of those pleadings, you rest?

Mr. Townsend: Yes, your Honor.

Mr. Reed: Petitioner rests.

The Court: Do I understand you didn't want to file any briefs?

Mr. Reed: If your Honor please, I feel that the authorities are so complete on the problem here, that the Court might well decide this case at this time without the necessity of filing briefs.

The Court: The statute provides we must write an opinion on all these cases, anyway, and I would rather take the case under advisement. If you would care to file some short memorandum brief of your authorities, it might be helpful to the Court.

Mr. Reed: At this time?

The Court: Well, you have, under the rules, 45 days in which to file, and then 30 days after in which to file an answer.

Mr. Reed: Will these be simultaneous briefs?

The Court: I think so. They can be either. I like simultaneous briefs. [17]

Well, then, subject to the introduction of the pleadings, and any objection counsel might make, do you want to make any objection now on the record?

Mr. Reed: Yes, if your Honor please, I object

to the admission of those pleadings as not being proper evidence in this proceeding; they are not admissible for any purpose.

The Court: Objection will be overruled.

The pleadings, when they come here, will be marked Exhibits C and D; that will be the complaint and the answer.

Mr. Townsend: It will be D and E. We will have one that will be—we have one further exhibit that will be attached.

The Court: It will be attached to this 3-C, will be attached to the stipulation. Then these will be D and E.

The exhibit will be admitted and caused as submitted. Counsel may file briefs, simultaneous briefs, in 45 days, and file briefs 30 days thereafter if they wish.

The Clerk: The dates are July 22nd and August 21st; August 21st for the reply briefs.

(Whereupon, at 10:50 o'clock a.m., the hearing was closed.) [18]

[Endorsed]: T.C.U.S. Filed July 1, 1957.

29 T. C. No. 7

Tax Court of the United States

N. Gordon Phillips, Petitioner, v. Commissioner of Internal Revenue, Respondent.

Lauretta M. Phillips, Petitioner, v. Commissioner of Internal Revenue, Respondent.

Docket Nos. 58561, 58562. Filed October 16, 1957.

Held, petitioner received all of the proceeds from the 1951 sale of stock under a claim of right so as to be taxable thereon in that year, despite the fact he was obliged in a later year to pay back the proceeds received from the sale of a portion of the stock, pursuant to the mandate of a state court decree.

Sidney R. Reed, Esq., for the petitioners.

Mark Townsend, Esq., for the respondent.

OPINION

Mulroney, Judge: The respondent determined a deficiency in the income tax of the petitioners in these consolidated cases for the calendar year 1951 in the amount of \$15,525.59. The sole issue in controversy here is whether the proceeds from the sale of certain stock, reported as income in the 1951 joint return of petitioners, can be included in that year's income when it appeared petitioners were obliged to pay back such proceeds to a claimant in a later year.

Most all of the facts were stipulated and the stip-

ulated facts are found accordingly. N. Gordon Phillips and Laurretta M. Phillips, petitioners in these consolidated cases, are husband and wife residing in Beverly Hills, California. They filed a joint income tax return for 1951 with the then collector of internal revenue for the sixth district of California at Los Angeles, California. Petitioner, N. Gordon Phillips, will hereafter sometimes be referred to as petitioner, as Laurretta is only interested in the case by virtue of the community property laws of California and her liability under the joint income tax return for 1951.

Petitioner organized and promoted the Gordon Oil Company, a California corporation organized on January 30, 1949. For his services and for the transfer of certain leasehold interests, he was to receive one-half of the stock of the said company. A permit was issued by the Corporation Commissioner for the State of California in March 1949, authorizing the issuance of 13,000 shares of stock to petitioner and the sale of an additional 13,000 shares at a par value of \$10, and providing that all shares should be held in escrow and that petitioner should receive no dividends on his shares until the purchasers of shares for cash had been reimbursed for the full purchase price.

Petitioner sold 1,790 shares of stock to other parties, and in March of 1949 the Corporation Commissioner consented to the transfer of said 1,790 shares within escrow to the names of such purchasers. In August 1949 a written instrument was

executed by petitioner and G. W. Raichart under the terms of which petitioner purportedly agreed to give "For promotional services rendered", when received by petitioner from escrow, 320 shares of the capital stock of the Gordon Oil Company.

G. W. Raichart died on December 27, 1950, and shortly thereafter petitioner put through a transaction with a man named Kline wherein the latter agreed to purchase all of the stock of the Gordon Oil Company. On March 21, 1951, petitioner received 11,210 shares out of escrow (13,000 shares less 1,790 shares previously transferred) and on or about the same date sold them to Kline for \$1,689,-347. In August 1951 the Gordon Oil Company was dissolved, thereby extinguishing all of its outstanding shares.

Petitioner treated all of the shares of stock and the proceeds received from the sale of stock as his own, reporting the gain from the sale on his 1951 income tax return.

In February 1952 the widow of G. W. Raichart, as executrix of his will, brought an action in the Superior Court of California against petitioner for breach of contract and for conversion with respect to the 320 shares of stock which was the subject of the aforementioned instrument executed by petitioner and Raichart. Petitioner resisted the claim, asserting that the instrument executed by him and Raichart was never intended to be an agreement and was void; that it was executed without consideration; and in the alternative that the written

agreement had been canceled and extinguished by an oral agreement between the parties. In December 1952 the Superior Court rendered a decision and judgment in favor of the plaintiff holding the defendant in that action, petitioner here, was guilty of conversion of 320 shares of the Gordon Oil Company stock. Since the stock had been disposed of a money judgment was awarded the plaintiff in that action. The District Court of Appeals, Fourth District of California, affirmed the judgment and an appeal to the Supreme Court of California was denied. Petitioner paid the judgment, together with interest, in the amount of \$56,755.73 in 1953.

In his 1953 return Phillips did not claim a deduction for the payment of the judgment. In 1953 his operations, without regard to the payment of the judgment, resulted in a loss and he had no taxable net income for that year.

The deficiencies set forth in the statutory notices are due to the reduction in the basis of the 11,210 shares of Gordon Oil Company stock sold and reported by petitioner. Petitioner does not contest this reduction in basis but contends that he is entitled to reduce the sales proceeds reported in his 1951 return by the amount of money received for the 320 shares of stock, which money he was obliged to refund in 1953, pursuant to the judgment of the California Courts.

Respondent contends that the proceeds were received by petitioner under a claim of right without restriction as to their disposition, and they are tax-

able to petitioner in 1951, the year they were received and retained even though in a later year, in 1953, the petitioner was obliged to refund them.

We agree with the respondent that the portion of the proceeds received from the sale of the 320 shares in 1951 was taxable income to the petitioner for that year even though he was later obliged to return the portion of the proceeds received from such sale. The "claim of right" doctrine, which supports respondent, had its origin in *North American Oil Consolidated v. Burnet*, 286 U.S. 417. The opinion explains the doctrine as follows:

If a taxpayer received earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. * * *

There is no need to go into a general discussion of the claim of right doctrine. It has been applied many times. See *Healy v. Commissioner*, 345 U.S. 278; *Rutkin v. United States*, 343 U.S. 130; and *Michael Phillips*, 25 T.C. 767, *aff'd*. 238 F. 2d 473.

The facts of this case bring it clearly within the claim of right doctrine. Petitioner treated all 11,210 shares of stock which he received from escrow as his own and he sold the stock in 1951 and treated the entire proceeds from such sale as his own. It was not until 1952 that a claim was filed against the

portion of these proceeds representing the 320 shares claimed by Raichart's estate. Petitioner continued to claim his right to the proceeds from the sale of these 320 shares of stock. In what petitioner terms a "hotly contested adversary proceeding" it was ultimately decided that petitioner's claim of right was invalid.

Since petitioner retained the proceeds from the sale of the 320 shares of stock under claim of right without restriction as to the disposition of said proceeds, he is taxable in the year of sale, regardless of any infirmity in his title and despite the fact that he was obliged to refund the proceeds of said sale in 1953.

Petitioner argues that judgments of state courts in matters of title to property must be respected and here the California State Court ruled the 320 shares belonged to Raichart's estate and no income tax can be exacted from petitioner on the proceeds of the sale of that stock. But petitioner realized income from the sale of this stock in 1951, which he claimed as his own and which he retained at the close of the year. The force of the California judgment compelling the pay-back is recognized and petitioner's complying with the mandate of the judgment will give him a deduction from income in the year it is made.

Petitioner's real argument is in effect an equitable appeal. Petitioner's operations were such that in 1953 when he paid the \$56,755.73, he had no taxable income, and, he argues, unless he prevails

here, he will be without remedy and respondent will be exacting a tax on income which he reported but was not allowed to retain. But a cardinal principle of Federal income taxation requires annual returns and accounting. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359. This principle requires the determination of income at the close of the taxable year without regard to the effect of subsequent events. One can admit the equities of the situation favor petitioner but this Court must decide the case according to the applicable law for the taxable year.¹

Decisions will be entered for the respondent.

Served and Entered October 16, 1957.

¹ It is to be observed that Congress granted some relief in this area by providing, in section 1341 of the 1954 Code, that where a taxpayer is required to restore an amount, in excess of \$3,000, which was included in his income in a prior year under a claim of right, he may either (1) claim a deduction in the current year for the amount so restored, or (2) eliminate the amount so restored from the income of the prior year and decrease his current year's tax by the resulting decrease in tax for the prior year, with special rights for credits and refunds in certain situations.

The Tax Court of the United States
Washington

Docket No. 58561

N. GORDON PHILLIPS, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion, filed October 16, 1957, it is

Ordered and Decided: That there is a deficiency in income tax for the calendar year 1951 in the amount of \$15,525.59.

Entered Oct. 16, 1957.

[Seal] /s/ JOHN E. MULRONEY,
Judge.

Served and Entered Oct. 18, 1957.

The Tax Court of the United States
Washington

Docket No. 58562

LAURETTA M. PHILLIPS, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion, filed October 16, 1957, it is

Ordered and Decided: That there is a deficiency in income tax for the calendar year 1951 in the amount of \$15,525.59.

Entered Oct. 16, 1957.

[Seal] /s/ JOHN E. MULRONEY,
Judge.

Served and Entered Oct. 18, 1957.

[Title of Tax Court and Docket Nos. 58561-2.]

PETITION FOR REVIEW OF DECISION
OF TAX COURT

Come now petitioners N. Gordon Phillips and Lauretta M. Phillips, his wife, and respectfully petition for a review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court rendered in the above entitled matter, the two cases being consolidated for hearing, and respectfully allege:

I.

The above entitled proceeding involves the petitioners' income tax for the year 1951.

The controversy relates to the question of the amount of capital gain realized by petitioners on the sale of certain oil stock in 1951. Petitioners reported the gain realized from the sale of 11,210 shares of said stock. In an adversary proceeding, the Superior Court in and for the State of California, County of San Diego, held in 1952 that 320 of said shares had at all times been owned by a third party. The District Court of Appeals, Fourth

District, California, affirmed the judgment. Appeal to the Supreme Court of California was denied. Petitioners paid a money judgment in 1953 but received no tax benefit therefrom.

It was the decision of the Tax Court herein that the entire proceeds from the 1951 sale of stock were held by petitioners under a claim of right and that they were taxable on the entire gain despite the fact they were obligated in 1953 to pay the proceeds received from the sale of 320 of said shares to a third party pursuant to the decision of the California court.

It is the contention of petitioners that the California court having determined that said 320 shares of stock were never owned by them they cannot legally be taxed on the gain derived from the sale of said shares.

II.

The review is sought before the United States Court of Appeals for the Ninth Circuit.

III.

The petitioners at all times herein mentioned have resided and now reside in the County of Los Angeles, State of California; that their joint income tax return for the year involved was filed with the District Director of Internal Revenue, Los Angeles, California.

That the place where petitioners reside, and the place where the office of said District Director of Internal Revenue is located is within the Circuit of the United States Court of Appeals for the Ninth

Circuit, and said Court is the Court having jurisdiction of a review of the decision of the Tax Court herein under the provisions of Section 7482 of the Internal Revenue Code.

That the decision of the Tax Court was entered herein October 16, 1957; and a Motion for Review By Full Court was denied November 1, 1957; that the time for filing a Petition for Review will expire February 1, 1958.

Wherefore, your petitioners pray that a review be had of the decision of the Tax Court rendered in the above entitled matter, and that upon such review said decision be reversed.

Respectfully submitted,

/s/ A. L. BURFORD, JR.,
Attorney for Petitioners
on Review.

Affidavit of Service by Mail and Notice of Filing Attached.

[Endorsed]: T.C.U.S. Filed January 9, 1958.

[Title of Tax Court and Docket Nos. 58561-2.]

CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 17, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation of Contents of Record on Review" and "Supplemental Designation of

Contents of Record on Review'', including Exhibits 1-A thru 3-C, attached to the Stipulation of Facts, and Respondent's Exhibits D and E, admitted in evidence, in the cases before the Tax Court of the United States docketed at the above numbers and in which the petitioners in the Tax Court have filed a petition for Review as above numbered and entitled, together with a true copy of the docket entries in said Tax Court cases as the same appear in the official docket in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 3rd day of February, 1958.

[Seal] /s/ HOWARD P. LOCKE,
Clerk, Tax Court of the
United States.

[Endorsed]: No. 15890. United States Court of Appeals for the Ninth Circuit. N. Gordon Phillips and Laurretta M. Phillips, Petitioners, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed: February 11, 1958.

Docketed: February 18, 1958.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit

Case No. 15890

N. GORDON PHILLIPS and LAURETTA M.
PHILLIPS, Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

STATEMENT OF POINTS ON WHICH
APPELLANTS WILL RELY

1. The Tax Court of the United States erred in holding that the proceeds received from the sale of 320 shares of stock, which in fact were the property of a third person, constituted taxable income to appellants when received by them in 1951.

2. The Tax Court of the United States erred in holding that the facts bring appellants' case clearly within the "claim of right doctrine".

3. The Tax Court of the United States erred in finding that appellants held the proceeds from the sale of said 320 shares of stock, which were in fact the property of a third person, without restriction as to the disposition of said proceeds.

4. The Tax Court of the United States erred in holding that there is a deficiency in appellants' federal income taxes for the year 1951 in the amount of \$15,525.59.

/s/ A. L. BURFORD, JR.,

Attorney for Appellants.

[Endorsed]: Filed March 28, 1958. Paul P.
O'Brien, Clerk.

[Title of Court of Appeals and Cause.]

DESIGNATION OF RECORD BY
APPELLANTS

Pursuant to Rule 17(6) of this Court, appellants hereby designate the following for inclusion in the printed record.

(1) Docket entries of all proceedings before the Tax Court of the United States.

(2) Pleadings before the Tax Court of the United States as follows:

(a) Petitions

(b) Answers

(3) Stipulation of Facts with Exhibits 1-A through 3-C attached.

(4) Respondent's Exhibits D and E admitted in evidence.

(5) Transcript of Trial.

(6) Opinion.

(7) Decision (Docket No. 58561).

(8) Decision (Docket No. 58562).

(9) Petition for Review.

(10) Designation of Contents of Record on Review.

(11) Supplemental Designation of Contents of Record on Review.

/s/ A. L. BURFORD, JR.,
Attorney for Appellants.

[Endorsed]: Filed March 28, 1958. Paul P. O'Brien, Clerk.

No. 15890

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

N. GORDON PHILLIPS and LAURETTA M. PHILLIPS,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR THE PETITIONERS.

A. L. BURFORD, JR.,
523 West Sixth Street,
Los Angeles 14, California,
Attorney for Petitioners.

FILED

JUL 23 1938

PAUL J. GORDON & CO.

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No. 15890

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

N. GORDON PHILLIPS and LAURETTA M. PHILLIPS,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR THE PETITIONERS.

Opinion Below.

The opinion of the Tax Court is reported at 29 T. C. No. 7.

Jurisdiction.

This petition for review [R. 45-47] involves federal income taxes for the taxable year 1951. On April 15, 1955, the Regional Commissioner of Internal Revenue at Los Angeles, California, mailed to the taxpayers a notice of deficiency in the total amount of \$15,525.59. [R. 8.] Within ninety days thereafter and on June 21, 1955, each taxpayer filed a separate petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code of 1939, as amended. The petitions were consolidated for trial. A decision of the Tax Court in each proceeding was entered

on October 16, 1957, for the full amount of the deficiency. [R. 44.] On October 28, 1957, motions by taxpayers for review by the full court were denied. [R. 4.] This case is brought to this Court by a petition for review filed January 9, 1958. [R. 45-50.] Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

Question Presented.

Did the Tax Court err in holding that money received by taxpayers in 1951 from the sale of certain shares of stock owned by a third person was held by taxpayers under a "claim of right" without restriction as to its disposition so that the gain realized from said sale was properly taxable to them in 1951 under Section 22(a) of the Internal Revenue Code of 1939 even though they were later obligated to pay over the proceeds received from such sale to the owner of the stock?

Statute and Regulations Involved.

These are set out in the Appendix, *infra*.

Statement.

The facts as stipulated by the parties [R. 18-22] and as found by the Tax Court [R. 37-41] may be summarized as follows:

Taxpayers are husband and wife. They filed a joint federal income tax return for the taxable year 1951. The income therein reported was community income. [R. 19.]

Taxpayer, N. Gordon Phillips, organized a California corporation in 1949 known as the Gordon Oil Company. He received one-half of the stock of said company consisting of 13,000 shares in consideration for his services and

the transfer to it of certain leasehold interests. The other half of the stock was sold. All of the stock was held in escrow in compliance with the terms of the permit issued by the Commissioner of Corporations of the State of California. [R. 19.]

In August, 1949, taxpayer, N. Gordon Phillips, and G. W. Raichart executed a written instrument under the terms of which Phillips agreed to give Raichart 320 shares of capital stock when received from the escrow "for promotional services rendered." [R. 20.]

G. W. Raichart died on December 27, 1950. On March 21, 1951, pursuant to a sale of all of the stock of said company Phillips received 11,210 shares out of escrow (13,000 shares less 1,790 shares previously transferred) and on or about the same date sold them for \$1,689,347.00. The above sale included the 320 shares Phillips had agreed in writing to transfer to G. W. Raichart when received from escrow. The money received for the 320 shares was not remitted to Raichart's estate but was retained by Phillips. [R. 20, 24.]

On February 14, 1952, the executrix of the estate of Dr. Raichart brought an action in the Superior Court of the State of California in and for the County of San Diego for damages for breach of contract against taxpayer, N. Gordon Phillips, with a second count for conversion involving the right to the 320 shares of stock of Gordon Oil Company which were the subject matter of the written agreement dated August 18, 1949. The Court entered judgment against taxpayer in the amount of \$49,920.00 together with interest of \$6,687.08 and cost of suit of \$148.65. It found that on December 27, 1950, the date of Dr. Raichart's death, he was the owner of and entitled to immediate possession of said 320 shares of

stock when released from escrow, and that Valli D. Raichart, as executrix, was entitled to immediate possession of said shares as of January 24, 1951. It further found that on January 24, 1951, taxpayer Phillips unlawfully sold and disposed of said 320 shares and converted the same to his own use and benefit and received the proceeds thereof in the amount of \$49,920.00 and ever since then had retained the proceeds. The Court further found that the agreement of August 18, 1949, was signed and executed for a good and valuable consideration and that said agreement had not since been cancelled, changed, modified or extinguished except by the breach thereof by taxpayer Phillips. The District Court of Appeal, Fourth District, California, affirmed the judgment of the Superior Court and the decision is reported in 120 Cal. App. 2d 645, 261 P. 2d 777. Appeal to the Supreme Court of California was denied. [R. 21, Jt. Ex. 2-B.]

Taxpayer paid the judgment together with interest and costs, a total of \$56,755.73, in 1953. [R. 22, Jt. Ex. 3-C.]

Taxpayers treated the gain realized on the sale of said 320 shares of stock as their own, reporting the gain from the sale in their 1951 income tax return. [R. 39.] In their 1953 return taxpayers did not claim a deduction for payment of judgment. [R. 40.]

On these facts the Tax Court found that the gain on the portion of the proceeds received from the sale of the 320 shares of stock in 1951 was taxable income to taxpayers for that year even though they were later obligated to return the portion of the proceeds received from such sale. [R. 41.] Mr. and Mrs. Phillips have petitioned the Court to review this holding. [R. 45.]

Attention of the Court is also invited to the fact that a joint income tax return was filed for the year 1951 but

that separate decisions in the full amount of the deficiency were entered against both taxpayers as a result of separate petitions to the Tax Court having been filed. As a consequence taxpayers at the present time are liable for twice the amount of the correct deficiency as found by the Tax Court. This is obviously erroneous as there should be one judgment in the amount of the deficiency constituting a joint and several liability of taxpayers.

Specification of Errors.

1. The Tax Court erred in failing to give proper effect to the state court judgment that the 320 shares of stock were not owned by taxpayers but by a third person at the time of their sale and conversion.

2. The Tax Court erred in holding the gain realized on the sale of the 320 shares of stock taxable to taxpayers in 1951, based on its finding that the proceeds were held by them under a "claim of right" and without restriction as to the disposition of the proceeds.

Summary of Argument.

The Commissioner held that taxpayers were properly taxable in 1951 on the gain realized from the sale of 320 shares of stock which were in fact owned by a third person but which were unlawfully sold and disposed of by taxpayer, who converted them to his own use and benefit and received the proceeds of sale for himself in that year.

The Tax Court sustained this determination. It held this gain taxable to taxpayers on the basis of its finding that the proceeds of sale were held by them in 1951 under a "claim of right" and without restriction as to the disposition of the proceeds of the sale regardless of the fact that taxpayers did not own the stock and were obli-

gated to pay over the proceeds to the owner in a subsequent year.

The Tax Court further held that it was giving proper effect to the judgment of the state court determining the ownership of the stock by stating:

“* * * The force of the California judgment compelling the payback is recognized and petitioner’s complying with the mandate of the judgment will give him a deduction from income in the year it is made.”

The proper tax result, based on the state court’s determination of the ownership of the stock, is to tax the gain on its sale to the owner and not to these taxpayers. The result of this decision is to tax the gain to taxpayers in 1951 and to tax the very same gain again when paid over to the owner in 1953 with no corresponding deduction. This inequitable result is contrary to the well established rule of law that income follows the property right as determined by the state court.

The actual facts of this case are not in dispute. However, the demarcation between findings of fact by the Tax Court and legal conclusions based on those findings is not clearly delineated in the opinion of the Tax Court. The opinion states that “The facts of this case bring it clearly within the claim of right doctrine.” [R. 41.] It further states that since taxpayer retained the proceeds from the sale of stock “under claim of right without restriction as to the disposition of said proceeds he is taxable * * *.” [R. 42.]

Counsel knows of no cases involving the so-called "claim of right" doctrine which involve facts similar to those of this case. The above quoted statement that taxpayer held the money under a claim of right and without restriction is an erroneous legal conclusion of the court not supported by the facts. Taxpayer at no time had any right to the proceeds, and they were at all times subject to the restriction of the written agreement with the owner of the stock. The breach of the agreement and the conversion of the shares did not give taxpayer a claim to the proceeds or unrestricted use of them. This is clearly demonstrated by the sequence of events. The stock was converted on January 24, 1951, approximately one month after Raichart's death, but after the appointment of his executrix on January 12, 1951. The complaint for damages for breach of contract, for conversion, was filed February 14, 1952. This was even before the due date for the filing of 1951 income tax returns. [Jt. Ex. 2-B.] Thus this is not a case where the question of ownership of property arose only in connection with a taxpayer's defense to a deficiency or fraud charge in an income tax case and where there was little if any likelihood that the owner would ever attempt to secure possession of the property. As soon as the executrix had inventoried the assets in her husband's estate and determined that the agreement with her husband would not be carried out voluntarily she commenced an action to enforce it. The statutory notice of deficiency was not sent to taxpayers until April 15, 1955, over three years after the suit was filed and after the judgment had been paid, which was in 1953.

Taxpayer's arguments as summarized above will be presented under the following points of law:

I.

The gain realized from the sale of the stock is properly taxable to the owner thereof as determined by the state court in an adversary proceeding.

II.

The application of the claim of right doctrine to the facts in this case does not result in the gain from the sale of the stock being properly taxable to the taxpayers.

(a) This is not a case of when income is taxable but whether taxpayers received any gain or profit from the sale of the stock within the reach of Section 22(a) of the Internal Revenue Code of 1939.

(b) Taxable gain under these facts is conditioned upon the presence of a bona fide legal or equitable claim of right to the alleged gain and the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain.

(c) All relevant facts and circumstances must be considered.

POINT I.

The Gain Realized From the Sale of the Stock Is Properly Taxable to the Owner Thereof as Determined by the State Court in an Adversary Proceeding.

It is clear that the Commissioner is bound by a decision of a state court determining the ownership of property where the litigation is adversary in nature. The question is the proper application of this legal principle to the facts of this case. The Tax Court recognized this rule of law but stated that it was being given full effect as heretofore indicated. It is submitted that the Court erred in this respect.

The proper application of this rule of law is clearly demonstrated by *Estate of A. Bluestein*, 15 T. C. 770 (1950; Acq. 1951-1 C. B. 1). Although also involving estate tax, we are here concerned with the portion of the case dealing with the taxation of the income to the decedent for the period January 1, 1944, to the time of his death on September 18, 1944. Clearly decedent treated all the income as his own. The Commissioner contended that all of it should therefore be taxed to him in his final return. The Texas court had held in an unreported declaratory judgment on March 1, 1945, which was affirmed, that one-half of the property producing this income was not owned by decedent but by other heirs of his deceased wife, namely, sons. The Tax Court stated at page 785:

“* * * The Texas decree determined that the decedent owned only one-half of the business and the other assets standing in his name and that he held his sons’ interests in trust for them. It follows that only the income from the decedent’s one-half interest

should be taxed to him for the period January 1, 1944, to the date of his death on September 18, 1944, and to his estate for the period before us when the estate was in administration, viz., the fiscal years ending August 31, 1945, and August 31, 1946. The income accruing to the sons for their interests during the above periods was paid or credited to them and the decedent or his estate had no legal claim to it."

It is difficult to see how a greater claim of right to property and his income could be asserted than was asserted by decedent in this case. His wife died in 1919. He died in 1944. He had thus claimed property belonging to his sons together with the income therefrom for 25 years. When he died he was still claiming the income. His taxable year 1944 ended before the entry of the judgment of the Texas court on March 1, 1945. None the less the Tax Court had no difficulty in holding that the income followed the property ownership and that the income realized from the property which the court held belonged to the sons should be taxed to them and not to decedent.

The Tax Court opinion indicates that the Texas court determined that decedent held his sons' interests in trust for them. It is clear that this was not a testamentary trust or an express trust. It apparently was a constructive trust. The same would be true in the case before this Court. Section 2223 of the California Civil Code provides that one who wrongfully detains a thing is an involuntary trustee and that he holds it for the benefit of the owner.

If the income claimed by Bluestein until his very death but in fact owned by his sons was properly taxable to the sons, *a fortiori* the gain on the sale of the stock owned by Raichart but claimed by taxpayers should likewise be taxed to the owner of the property.

POINT II.

The Application of the Claim of Right Doctrine to the Facts in This Case Does Not Result in the Gain From the Sale of the Stock Being Properly Taxable to the Taxpayers.

- (a) This Is Not a Case of When Income Is Taxable but Whether Taxpayers Received Any Gain or Profit From the Sale of the Stock Within the Reach of Section 22(a) of the Internal Revenue Code of 1939.

The issue in this case is not whether 1951 was the proper year in which to tax the gain on the sale of the stock in question to these taxpayers. The issue is whether such profit ever represented gains or profits to these taxpayers within the reach of Section 22(a) of the Internal Revenue Code of 1939. If there was such gain it obviously was taxable to these taxpayers in 1951.

The so-called "claim of right" doctrine, whatever its shortcomings and limitations in actual application, is now a firmly embedded judicial gloss on the statutory tax structure. However, properly interpreted it is submitted that this concept reaches only to the question of when income is properly reported or a deduction properly claimed under our system of annual accounting periods. As stated by Judge Mulroney in his Tax Court opinion in this case [R. 41] the doctrine had its origin in the well known case of *North American Oil Consolidated v. Burnet*, 286 U. S. 417. No useful purpose would be served by an extended discussion of this case. It should be pointed out nevertheless that it involved a dispute as to title to property. Because of this dispute between the Government and the taxpayer the income from the property was impounded by a receiver in 1916. In 1917 the net profits from 1916 operations were paid over to the taxpayer

by the receiver pursuant to court decree based on the court's decision that the taxpayer had title to the property. Even though the Government appealed and the case was not finally settled until 1922, the Court held the 1916 net profits taxable to the company in 1917 because the taxpayer became entitled to them in that year and actually received them. The fact that the Government might win on appeal was not considered to be a contingency of sufficient moment to warrant the taxpayer's postponing the reporting of the income for tax purposes.

In the last several years there have been a great number of cases involving the claim of right doctrine. These cases primarily involve the correct correlation of recognized business accounting concepts of accrual of income or expense items with the requirements of tax accounting. They have no bearing on the issue before this Court. This is also true of *Michael Phillips*, 25 T. C. 767, aff'd 238 F. 2d 473, cited in the opinion below. [R. 41.] This case involved the proper time for the reporting of a contingent fee received by an attorney in connection with a case which was later reversed. *Healy v. Commissioner*, 345 U. S. 278 cited in the opinion below [R. 41] likewise involved this same general principle and concerned salaries found to be unreasonable in amount. The corporation was unable to pay the tax deficiency. The stockholder-employees who received the excessive salaries paid the corporation's tax deficiency because of their transferee liability. The question before the court was whether the taxpayers were taxable on the entire amount of their salaries in the year paid or whether an adjustment should be made because of the subsequent repayment of a portion thereof. The taxpayers argued that they received the salaries as "constructive trustees" for the benefit of the

creditors of the corporation. The court stated that admittedly receipts by a trustee expressly for the benefit of another are not income to the trustee in his individual capacity. However, the constructive trust in this case resulted from the equitable doctrine that funds of a corporation are a trust fund for the benefit of creditors if received by a stockholder without adequate consideration from an insolvent corporation. There was nothing illegal or unlawful in connection with the salaries and it could not have been said at the end of each of the years involved that the transferee liability would ever materialize. Thus, a potential or dormant restriction on the use of the salaries which depended upon the future application of rules of law to present facts was not a "restriction on use" within the meaning of *North American Oil Consolidated v. Burnet*, *supra*.

- (b) Taxable Gain Under These Facts Is Conditioned Upon the Presence of a Bona Fide Legal or Equitable Claim of Right to the Alleged Gain and the Absence of a Definite, Unconditional Obligation to Repay or Return That Which Would Otherwise Constitute a Gain.

In the case before this Court the taxpayers at no time owned the stock in question. If the owner of the stock had sold it and had paid taxpayers a commission which for some reason such as mistake in computation had later been refunded in part, or if the sale on which the commission was based had fallen through and the commission had been refunded, then the case would have been analogous to those referred to above. Here, however, stock owned by another was unlawfully sold and disposed of and converted to taxpayer's own use and benefit. [Jt. Ex. 2-B, p. 2.]

In short, it is submitted that there was never any bona fide legal or equitable claim by taxpayer to the stock in question within the meaning of that term as used in the "claim of right" cases. This appears to be tacitly admitted by the Court below in its citation of *Rutkin v. United States*, 343 U. S. 130. [R. 41.]

Here if the taxpayer was not holding the stock as trustee for the owner he was at least holding it as bailee for his principal, and he unlawfully converted to it his own use with the intent of depriving the owner of his property unlawfully. There was no occasion here to resort to a constructive trust, referred to by the court in *Healy v. Commissioner, supra*, as a legal fiction. There was a clear breach of a written agreement in this case.

It is submitted that under these circumstances taxpayer never had a bona fide claim of right to the proceeds from sale of the stock, no matter how untenable, nor did he at any time hold the money without restriction on its use and disposition.

If this analysis is sound, a careful consideration of the cases involving taxation of property received as a result of the illegal act of the taxpayer is required. Counsel does not have the temerity to represent that he can satisfactorily reconcile the principles enunciated in *Rutkin, supra*, with those in *Commissioner v. Wilcox*, 327 U. S. 404, in which the Supreme Court affirmed the decision of this Court, where others have failed. None the less, certain important factors can be pointed out which, it is believed, should control the disposition of the instant case.

In the *Wilcox* case an embezzler was held not to have received gains or profits within the meaning of Section

22(a) of the Internal Revenue Code of 1939. The court held that a taxable gain is conditioned on two things: (a) the presence of a claim of right to the alleged gain, and (b) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain. The bare receipt of money or property wholly belonging to another lacks the essential characteristics of a gain or profit within the meaning of Section 22(a). All right, title and interest in and to the money embezzled rested with Wilcox's employer. The debtor-creditor relationship was definite and unconditional and the employer had at no time condoned or forgiven the debt.

Interestingly enough in *Rutkin, supra*, the Court did not once mention "claim of right." Obviously the extortioner had no claim of right to the money and could assert none. The Court premised its decision of the fact that the taxpayer had gain, unlawful though it might be, because of his control over the money. The cash was delivered to the taxpayer in a manner which allowed him full freedom to dispose of it at will because under the circumstances the payor was unlikely to repudiate the transaction and demand return of the money. Unless he did so the taxpayer could enjoy its use as fully as though his title to it were unassailable.

It is extremely important to note that the issue of extortion arose in defense to an income tax fraud case where the taxpayer's defense to his failure to report the receipt of the money was that it did not constitute taxable income. No action had ever been instituted by the payor to recover the money. In fact, as pointed out in the lower court (189 F. 2d 431, 436) the payor had left the taxpayer in undisputed possession of the money for eight years and had permitted the statute of limita-

tions to expire on whatever right he might have had to reclaim the money.

The Supreme Court in *Rutkin* limited the *Wilcox* case "to its facts." Subsequent to the *Rutkin* case a number of cases have followed *Rutkin*. In *Kann v. Commissioner*, 210 F. 2d 247 (3d Cir. 1954), sums improperly obtained from a corporation by controlling taxpayers were held to constitute taxable income. This case involved certain income tax deficiencies and fraud penalties for the years 1936 through 1941. The defense was that the sums in question had been embezzled and thus did not constitute taxable income. The court followed *Rutkin*. It stated there was no external evidence of the crime of embezzlement. The taxpayers were never indicted or convicted nor did it appear that those concerned with the corporation's affairs ever urged prosecution. Nor was there any proof in this case that the method of taking the money had not been condoned or that there was in fact any liability to repay the sums taken. Further here the taxpayers were to a large extent taking their own money.

In *Briggs v. United States*, 214 F. 2d 699 (4th Cir. 1954), the taxpayer was authorized to procure bids on surplus lands which his employer desired to sell. He and another person entered into an arrangement to sell the lands at prices in excess of those reported to the company and pocket the difference. They operated this fraudulent scheme over a period of years during which each received in excess of \$100,000, which he used as his own money. The company did not discover the fraud until after the individuals had been indicted for violation of the income tax laws. Obviously under these circumstances the taxpayer received money over which he had complete control with resulting economic value and for which he probably

never would have been required to account had it not been for the discovery of the fraud on the revenue.

In *Marienfeld v. United States*, 214 F. 2d 632 (8th Cir. 1954), the taxpayer had a contract with a company under which he was authorized to sell certain by-products from the boning of meat for the "account" of the company. He either failed to account for sales or reported sales for a smaller price than was actually the case. Upon audit of his income tax return for 1946 it was discovered that he had failed to report this money. His defense was that the money was embezzled and hence was not his income. The court held that the money so received was taxable income to the taxpayer and that the case was more nearly synonymous with *Rutkin* than *Wilcox* because of the nature of the taxpayer's possession, dominion over, opportunity for use of, and freedom to dispose of the funds in question. At most the taxpayer in this case had a deferred obligation to account for the funds which he collected.

United States v. Bruswitz, 219 F. 2d 59 (2d Cir. 1955), involved the failure of taxpayers to report bribes. The court commented on the cases discussed above following *Rutkin*. It stated at page 61:

"* * * Certainly the whole approach of the later case [*Rutkin*], stressing actual possession and control, is diametrically opposed to the 'claim of right' criterion of the earlier case. [*Wilcox*] The reconciliation evolved by other circuits seems to be that even temporary dominion over illicit gains is sufficient to render them taxable in the hands of the holder thereof [citing cases.] Although eminently justified by the *Rutkin* holding, this formulation in effect does what the Supreme Court purported not to do; it overrules the *Wilcox* case. * * *"

The Court then distinguished this case from the *Wilcox* case on the ground that there was no indication that the kickbacks resulted in any loss to the taxpayers' employers. It stated that although a presumption of such loss may be a sufficient basis on which to predicate a liability to the employers under state law, it was not sufficient to override the paramount interest of the government in assessing income taxes on the basis of beneficial enjoyment and control.

Berra v. United States, 221 F. 2d 590 (8th Cir. 1955), also involved income tax evasion. The business manager of a labor welfare organization arranged with a painting contractor to overstate his bills to the organization. He then approved and paid the bills and received the amount of the overpayment from the contractor. He contended these sums were not income because embezzled from his employer. The court held these funds to constitute taxable income. The money did not come from the employer but from a third person. Taxpayer might have been guilty of obtaining money by a fraudulent scheme or device but not by embezzlement, and he had complete control over the money.

In *Estate of Dix v. Commissioner*, 223 F. 2d 436 (2d Cir. 1955), the Court followed *Wilcox* and held that money appropriated by the president from a closely held family corporation was not taxable income. This money had been withdrawn from corporate bank accounts without the consent, coerced or otherwise, of the company. This was a simple case of embezzlement, not one involving a receipt under any color of right. The government's request for a writ of certiorari was denied.

Finally *Alice v. Prokop*, T. C. Memo. 1957-75, involved the failure to report for income tax purposes

funds diverted from a union. The years 1944 through 1947 were before the Tax Court. The audit which disclosed the diversions was begun in 1947. At least a substantial portion of the funds were restored to the union in consideration of a written release from the union. The Tax Court distinguished this case from *Wilcox* on the ground that there guilt of the particular crime had been established and adjudicated. Here the defense of embezzlement was an affirmative one with no adequate proof that the offense had not been condoned.

The only generalization counsel can draw from the above cases is that normally for a person to be taxable with respect to a particular item of property or money he must hold it under a bona fide claim of right and without a definite, unconditional obligation to repay or return it.

However, in cases of illegal activities there patently can be no holding under a claim of right. In the face of this assertion by taxpayers who failed to report the money derived from such activities the courts have been presented with a dilemma. They have quite properly been unwilling to hold that such gain does not result in taxable income, and gain there manifestly was. To have done so would have given preferential tax treatment to dishonest taxpayers. It is submitted that the key to the courts' decisions and the underlying rationale of the cases is the factual situation surrounding the restrictions, if any, on the use of the money or property in question and the likelihood of the taxpayer having to restore the money to the lawful owner.

(c) All Relevant Facts and Circumstances Must Be Considered.

The court below considered the law so clear, as applied to these facts, that it did not even require discussion. Yet it is equally clear that all relevant facts and circumstances of each case must be considered. Further, the line of demarcation in these cases is far from being sharply etched, and the undisputed facts in this case do not fall into the normal pattern.

As was pointed out in *Wilcox*, the mere receipt of property or money which one is obligated to return or repay to the rightful owner does not result in the receipt of taxable income. There must be something more. Thus the receipt of a loan, even though the borrower may not intend to repay, does not result in receipt of income because the obligation to repay arises at the very instant of the borrowing. A debtor-creditor relationship exists. The same situation exists in the case before this Court.

As pointed out above, it is counsel's opinion that the key to the courts' decisions and the underlying rationale of the type of case with which we are here concerned is the factual situation surrounding the restrictions on the control over and use of the money or property in question by the taxpayer and the likelihood of the taxpayer having to restore the money or property to the lawful owner. In considering the relevant facts and circumstances in the instant case it would appear there was not present the requisite extent of control over and use of the moneys in question by the taxpayer herein. This is true because at the very moment taxpayer unlawfully converted the 320 shares of stock owned by Raichart there arose a continuing obligation to repay the value thereof to the true owner. This continuing obligation had

its genesis in the written agreement of transfer of said stock to Raichart and attached itself to said moneys in such a manner as to be a continuing restriction on the control and use thereof by the taxpayer.

And, as distinguished from the *Rutkin* case and the cases following it, not only was it very likely that the taxpayer would have to restore the moneys to Raichart pursuant to the written agreement, which was in the possession of the executrix of Raichart's estate, it was practically a foregone conclusion judging from the state court decision wherein it was said, in essence, that it would tax the imagination of the court to believe the taxpayer's testimony as to his alleged claim to the moneys. Furthermore, this suit by the executrix was instituted promptly and had no connection with, nor did it result from, the later tax case here under consideration. This suit is not a mere possibility herein raised for the first time as an affirmative defense as in cases following *Rutkin*, but is one of the actual facts and circumstances which must be considered as an integral part of the record in this case.

No problem of protecting the revenue exists in this case. In practically all of the cases following *Rutkin* the taxpayer has sought to avoid payment of income tax or imposition of fraud penalties by raising the affirmative defense that the money in question did not represent gain within the meaning of Section 22(a) of the Internal Revenue Code of 1939. Here the taxpayer paid tax on the gain. This may have been self-serving as it was consistent with his position in the state court litigation. None the less the income was reported. It would also be taxed again in 1953 to the owner of the income when the judgment was paid. All taxpayer is here contending is that he erroneously overstated his income in

1951 by the amount of the gain reported on the sale of this stock. It was not gain to him under Section 22(a) of the Internal Revenue Code of 1939 because the stock never was owned by him, and he never held the proceeds without restriction on their use and disposition. The reporting of the gain having been in error, the correct amount of tax due should be determined in this proceeding.

Nor is this a case where the taxpayer was in rightful possession of funds for which he ultimately failed to account properly to his principal. Here the obligation to pay over was immediate and instantaneous as clearly held in the state court proceeding. This is in no sense the type of possession, dominion over, opportunity for use of, and freedom to dispose of funds that existed in the *Rutkin* case and cases which followed that decision.

It appears unnecessary to point out that the acts of the taxpayer in this case in unlawfully converting Raichart's property to his own use were never condoned but that legal action was promptly instituted by the lawful owner long before the tax case developed.

Under all the facts and circumstances of this case it is respectfully submitted that taxpayers realized no gain in 1951 from the sale of the 320 shares of stock owned by Raichart's estate within the meaning of Section 22(a) of the Internal Revenue Code of 1939.

Conclusion.

The decision of the court below is clearly erroneous and should be reversed.

Respectfully submitted,

A. L. BURFORD, JR.,

Attorney for Petitioners.

APPENDIX.

INTERNAL REVENUE CODE OF 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income.

REGULATIONS 111:

SEC. 29.22(a)-1 (As amended by T. D. 5600, Feb. 2, 1948.)

What included in gross income.—

Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits and income derived from any source whatever, unless exempt from tax by law. (Sections 22(b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 237, inclusive, and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or of property. * * *

THE CIVIL CODE OF THE STATE OF CALIFORNIA:

SEC. 2223. INVOLUNTARY TRUSTEE; THING WRONGFULLY DETAINED.

Involuntary Trustee, who is. One who wrongfully detains a thing is an involuntary trustee thereof, for the benefit of the owner.

No. 15,890

In the United States Court of Appeals
for the Ninth Circuit

N. GORDON PHILLIPS and LAURETTA M. PHILLIPS,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decisions of the
Tax Court of the United States

BRIEF FOR THE RESPONDENT

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
A. F. PRESCOTT,
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FILED

APR - 15 1958

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13-16.) The Commissioner filed answers (R. 12-13, 16-18) and a hearing was held on June 5, 1957 (R. 22-36). The decisions of the Tax Court sustaining the deficiency were entered on October 16, 1957. (R. 44-45.) Petition for review by this Court was timely filed on January 9, 1958. (R. 45-47.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Did the Tax Court err in holding that taxpayer realized taxable income upon his reported sale of certain stock in 1951 despite the fact that he became obliged to refund the proceeds thereof to a claimant in 1953?

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * *

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 42 [As amended by Section 114 of the
Revenue Act of 1941, c. 412, 55 Stat. 687].
PERIOD IN WHICH ITEMS OF GROSS INCOME
INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.22(a)-1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law.
* * *

* * * *

Sec. 29.42-1. *When Included in Gross Income.*—(a) *In general.*—Except as otherwise provided in section 42, gains, profits and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See sections 29.41-1 to 29.41-3, inclusive.) * * *

* * * *

STATEMENT

The pertinent facts, as stipulated (R. 18-22) and found (R. 38-40), appear as follows:

N. Gordon Phillips (hereinafter called the taxpayer) and Laurretta M. Phillips are husband and wife, residing in Beverly Hills, California. They filed a joint income tax return for 1951 with the then Collector of Internal Revenue for the Sixth District of California at Los Angeles, California. The wife is only interested in the case by virtue of the community property laws of California and her liability under the joint income tax return for 1951. (R. 38.)

The taxpayer organized and promoted the Gordon Oil Company, a California corporation organized on January 30, 1949. For his services and for the transfer of certain leasehold interests, he was to receive one-half of the stock of the company. A permit was issued by the Corporation Commissioner for the State of California in March 1949, authorizing the issuance of 13,000 shares of stock to the taxpayer and the sale of an additional 13,000 shares at a par value of \$10, and providing that all shares should be held in escrow and that the taxpayer should receive no dividends on his shares until the purchasers of shares for cash had been reimbursed for the full purchase price. (R. 38.)

The taxpayer (R. 20-21) sold 1,790 shares of stock to other parties, and in March of 1949 the Corporation Commissioner consented to the transfer of the 1,790 shares within escrow to the names of such purchasers. In August 1949 a written instrument (R. 20) was executed by the taxpayer and G. W. Raichart

under the terms of which the taxpayer purportedly agreed to give "For promotional services rendered", when received by the taxpayer from escrow, 320 shares of the capital stock of the Gordon Oil Company (R. 38-39).

G. W. Raichart died on December 27, 1950, and shortly thereafter the taxpayer put through a transaction with a man named Kline wherein the latter agreed to purchase all of the stock of the Gordon Oil Company. On March 21, 1951, the taxpayer received 11,210 shares out of escrow (13,000 shares less 1,790 shares previously transferred) and on or about the same date sold them to Kline for \$1,689,347. In August 1951 the Gordon Oil Company was dissolved, thereby extinguishing all of its outstanding shares. (R. 39.)

The taxpayer treated all of the shares of stock and the proceeds received from the sale of stock as his own, reporting the gain from the sale on his 1951 income tax return. (R. 39.)

In February 1952 the widow of G. W. Raichart, as executrix of his will, brought an action in the Superior Court of California against the taxpayer for breach of contract and for conversion with respect to the 320 shares of stock which was the subject of the aforementioned instrument executed by the taxpayer and Raichart. The taxpayer resisted the claim, asserting that the instrument executed by him and Raichart was never intended to be an agreement and was void; that it was executed without consideration; and in the alternative that the written agreement had been canceled and extinguished by an

oral agreement between the parties. In December 1952 the Superior Court rendered a decision and judgment in favor of the plaintiff holding the defendant in that action, the taxpayer here, was guilty of conversion of 320 shares of the Gordon Oil Company stock. Since the stock had been disposed of a money judgment was awarded the plaintiff in that action. The District Court of Appeals, Fourth District of California, affirmed the judgment and an appeal to the Supreme Court of California was denied. The taxpayer paid the judgment, together with interest, in the amount of \$56,755.73 in 1953. (R. 39-40.)

In his 1953 return Phillips did not claim a deduction for the payment of the judgment. In 1953 his operations, without regard to the payment of the judgment, resulted in a loss and he had no taxable net income for that year. (R. 40.)

The deficiencies set forth in the statutory notices were due to the reduction in the basis of the 11,210 shares of Gordon Oil Company stock sold and reported by the taxpayer. The taxpayer did not contest this reduction in basis but contended that he was entitled to reduce the sales proceeds reported in his 1951 return by the amount of money received for the 320 shares of stock, which money he was obliged to refund in 1953, pursuant to the judgment of the California Courts. (R. 40.)

The Commissioner contended that the proceeds were received by the taxpayer under a claim of right without restriction as to their disposition, and they were taxable to the taxpayer in 1951, the year they were received and retained even though in a later

year, in 1953, the taxpayer was obliged to refund them. (R. 40-41.)

The Tax Court concluded (R. 41) that "The facts of this case bring it clearly within the claim of right doctrine" and held (R. 41) that "the portion of the proceeds received from the sale of the 320 shares in 1951 was taxable income to the petitioner in that year even though he was later obliged to return the portion of the proceeds received from such sale."

SUMMARY OF ARGUMENT

The Tax Court correctly held, under the facts here obtaining, that the taxpayer realized taxable income in 1951, upon his sale of 320 shares of stock. On August 18, 1949, while the California Corporation Commissioner was requiring all of the Gordon Oil Company stock to be held in escrow, taxpayer privately contracted to turn over 320 shares to one Raichart "For promotional services rendered." On December 27, 1950, Raichart died. On March 21, 1951, the Corporation Commissioner released the stock from escrow and taxpayer sold all of the shares, including the 320 here in issue, to a third party purchaser of the newly organized corporation. The taxpayer treated the sales proceeds as his own and reported the gain from the sale on his 1951 income tax return. In 1952, Raichart's estate sued the taxpayer in the California Superior Court for breach of contract and conversion with respect to the 320 shares which constituted the subject matter of the August 18, 1949, agreement. The taxpayer vigorously defended this suit, claiming that the agreement with

Raichart was invalid. In 1953, after the Superior Court's judgment in favor of Raichart's estate had been affirmed, with appeal denied, the taxpayer paid the judgment. Relying on the state court's determination that the shares belonged to Raichart, he is here asserting that he was not taxable on the gain which arose, in 1951, on his sale of the 320 shares.

Clearly, as the Tax Court held, since the taxpayer received the sales proceeds in 1951 under claim of right without restriction as to their immediate use, he was, in law, properly taxable on the gain in the year of sale regardless of any infirmity in his title and despite the fact that he was obliged to refund the proceeds of such sale two years later. At the time of his receipt and sale of the stock, the lawful restriction of the escrow had been removed by the California Corporation Commissioner, thus freeing him to sell the shares as his own, which, in point of fact, he did. Under the well established federal tax principle requiring the filing of annual returns, the taxpayer was required to report the gain in 1951, the year in which his receipt of the sales proceeds without restriction as to use made the revenue ascertainable. Accordingly, within the clearly applicable "claim of right" rule, the taxpayer, under the established facts, realized income, in 1951, within the meaning of Section 22(a) of the 1939 Code. At the time of the sale, no restriction on taxpayer's immediate use of the proceeds was in existence. At most, there had been a breach of a private contract which, of itself, is not sufficient to postpone the realization of income. Moreover, when the subsequent suit was

brought, alleging the breach, the taxpayer vigorously asserted his claim to the sales proceeds throughout the various stages of the state court litigation. Not until the adverse judgment was affirmed, with appeal denied, did he recognize the validity of the estate's claim and pay over the sale proceeds, thus making an offsetting deduction possible in 1953. Again, the fact that the subsequent year's income might not be sufficient to permit tax benefit, deduction-wise, will not serve to disturb the realization of the income in the earlier year. Under Section 22(a), the equitable considerations, which cannot emerge in focus until the subsequent year, necessarily must give way to the annual accounting requirement that income must be reported in the year of realization—*viz.*, 1951.

Finally, no merit attaches to the taxpayer's contentions raised against the clear applicability of the "claim of right" principle to the here established facts. No serious attempt is made, on this score, to relate the various contentions to these facts. Within the clear meaning of the Supreme Court's pronouncements in *United States v. Lewis*, 340 U.S. 590, the final state court determination as to ownership of the 320 shares will not deprive the "claim of right" principle from applying, under these facts, to result in the realization of 1951 income, within the meaning of Section 22(a). Neither do the taxpayer's allegations of a constructive trust, a bailment, or a debtor-creditor relationship between the parties to the August 18, 1949, agreement serve to prevent the immediate realization of income by reason of the sale by the taxpayer in 1951. Neither can the tax-

payer's attempted analogy to *Commissioner v. Wilcox*, 327 U.S. 404, serve to blur the bona fides of his consistently asserted claim of right which he vigorously defended throughout the earlier civil litigation in California and here, quite inconsistently, attempts to disavow. Actually, the transactional treatment which the taxpayer seeks can only here be achieved by disregarding the uncontroverted facts, which clearly evidence his realization of income in 1951 within the ambit of both the annual accounting principle and the well established "claim of right" doctrine.

ARGUMENT

Under The Facts Here Obtained^{ing} The Tax Court Correctly Held That, Within The Meaning Of Section 22(a) Of The Internal Revenue Code Of 1939, Taxpayer Realized Taxable Income In 1951 Upon The Sale In That Year Of The 320 Shares Of Stock, Irrespective Of The Fact That He Later Became Obligated To Pay Over The Sales Proceeds By Reason Of A Judgment Entered Against Him In 1953

The Tax Court was correct in holding (R. 41), under the facts here obtaining, that the taxpayer realized taxable income in 1951, upon his sale (R. 20, 39) of the Gordon Oil Company shares to Kline on or about March 21st of that year. As the taxpayer flatly admitted, on cross-examination (R. 31), and as the Tax Court found (R. 39), the taxpayer treated all of the shares and the proceeds received from the sale *as his own* and reported all gain from the sale on his 1951 tax return. Moreover, in February, 1952, when C. W. Raichart's widow brought a breach of contract and conversion action against the tax-

payer in the California Superior Court (R. 39), the taxpayer, in what his own counsel described (R. 25) as "a hotly contested action" based on the purported agreement of August 18, 1949 (R. 20), denied * the validity of any claim by Raichart's estate to 320 shares "For promotional services rendered" (R. 20, 38-39). Only after the California Superior Court's judgment was affirmed, with appeal denied, did the taxpayer pay over the claimed amount, in 1953. (R. 41-42.)

Under these facts, since the taxpayer retained the proceeds of the 1951 sale of the 320 shares under claim of right without restriction as to the disposition of such proceeds, the law is clear that he was properly taxable in the year of sale, regardless of any infirmity in his title and despite the fact that he was obliged to refund the proceeds of such sale, in 1953. *North American Oil v. Burnet*, 286 U.S. 417; *United States v. Lewis*, 340 U.S. 590; *Healy v. Commissioner*, 345 U.S. 278; *Rutkin v. United States*, 343 U.S. 130; *Phillips v. Commissioner*, 25 T.C. 767, affirmed, 238 F. 2d 473 (C.A. 7th). The legal prin-

* See *Raichart v. Phillips*, 120 C.A. 2d 645, 261 P. 2d 777, where the court stated (p. 651):

The appellant contends that this agreement was not supported by any consideration, arguing that since all the stock of the corporation was sold prior to the execution of the contract there could be no promotional services for Raichart to perform thereafter; that a past consideration would not be sufficient in the absence of a preexisting legal obligation; and that there is no evidence that the loans previously made to Phillips by Raichart had anything to do with the making of the agreement in question.

ciple, which “is now deeply rooted in the federal tax system” (*United States v. Lewis, supra*, p. 592), was stated by the Supreme Court in the *North American Oil* case, *supra*, as follows (p. 424):

If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

Equally applicable, under these circumstances, is the established corollary federal tax principle requiring annual returns, with the tax being payable in the year—*viz.*, 1951—in which the receipt of the sales proceeds without restriction as to their use made the revenue ascertainable. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359. Under this principle, income is properly determined at the close of the taxable year, without regard to the effect of subsequent events. *Penn v. Robertson*, 115 F. 2d 167 (C.A. 4th). As the court stated in *National City Bank of New York v. Helvering*, 98 F. 2d 93, 96 (C.A. 2d):

It would be intolerable that the tax must be assessed against both the putative tortfeasor and the claimant; collection of the revenue cannot be delayed, nor should the Treasury be compelled to decide when a possessor's claims are without legal warrant. If he holds with claim of right, he should be taxable as an owner, regardless of any infirmity of his title; * * *

See also *United States v. Lesoine*, 203 F. 2d 123 (C.A. 9th), where this Court, rejecting a construc-

tive trust contention by taxpayer, stated (p. 126) :

It is unnecessary to decide whether the taxpayers had the right to retain the dividend under state law or whether they might have been adjudged liable to return it if an action had been brought against them for that purpose. It is plain that the taxpayers received and retained the dividend under a claim of right thereto during the taxable year 1942. The case falls within the familiar "claim of right" doctrine.

See also *Healy v. Commissioner*, 345 U.S. 278, 282-283. Manifestly, it would be difficult to devise a set of facts which could more compellingly demonstrate the correctness of the Tax Court's holding that the taxpayer's retention of the 1951 sales proceeds under claim of right, with no restriction as to immediate use, constituted the realization of income in that year, irrespective of any subsequent obligation which might arise to refund such proceeds in 1953.

Just as clearly, there is no merit in the taxpayer's contentions (Br. 9-22) to the contrary. His first contention (Br. 9-10) purports to rely on *Estate of Bluestein v. Commissioner*, 15 T.C. 770, as authority for the here irrelevant proposition that gain realized from the 1951 sale of the 320 shares should, under the state court decision in *Raichart v. Phillips*, *supra*, be taxable to the Estate of Raichart, as owner, and not to taxpayer. Incident to this contention (Br. 10) is the allegation that the taxpayer received the sales proceeds as a constructive trustee. For a combination of independently controlling reasons, the contention is erroneous. In the first place, it may be observed that, unlike *Bluestein*, which was primarily an estate

tax case, involving, collaterally, the includibility of income in both the decedent's final return and that filed by the executor for the period of administration, the instant case presents only the simple "claim of right" issue as to whether the taxpayer, as the only party before the Court, realized income, within the meaning of Section 22(a) of the 1939 Code, *supra*, on his 1951 sale of the stock in issue. Secondly, it is pertinent that the Tax Court's controlling estate tax determination, in *Bluestein*, as to includible assets, was stated (p. 783) to turn on recognition of an earlier state court determination of asset ownership under the express authority of *Freuler v. Helvering*, 291 U.S. 35. The *Bluestein* case was decided by the Tax Court on December 4, 1950. That the expressed reliance on *Freuler*, with respect to according controlling weight to a state court's determination of property rights, does not extend to a "claim of right" issue arising under Section 22(a) of the 1939 Code is made clear by the Supreme Court's subsequent decision in *United States v. Lewis*, *supra*, which was handed down on March 26, 1951. There, after quoting Mr. Justice Brandeis' familiar statement of the "claim of right" doctrine, initially laid down in *North American Oil v. Burnet*, *supra*, the Court stated (p. 591):

Nothing in this language permits an exception merely because a taxpayer is "mistaken" as to the validity of his claim. Nor has the "claim of right" doctrine been impaired, as the Court of Claims stated, by *Freuler v. Helvering*, 291 U.S. 35, or *Commissioner v. Wilcox*, 327 U.S. 404. The *Freuler* case involved an entirely dif-

ferent section of the Internal Revenue Code, and its holding is inapplicable here.

Again, the taxpayer cannot circumvent his realization of income in 1951 by alleging (Br. 12) that he received the sales proceeds in that year as a constructive trustee. Where, as here, the facts satisfy the "claim of right" rule for realization of income, it is well established that the constructive trust rationale is inapplicable. *United States v. Lesoine*, 203 F. 2d 123, 126-127 (C.A. 9th); *St. Regis Paper Co. v. Higgins*, 157 F. 2d 884, 885 (C.A. 2d), certiorari denied, 330 U.S. 843. Neither does he avoid the realization impact of the "claim of right" rationale by alternatively claiming (Br. 14) to have received the stock as a bailee. This contention ignores the basic fact that the issue is not whether taxpayer realized income on the receipt of the stock but whether the taxpayer realized income on the sale. In any event, where, as here, the facts of a particular case support the applicability of the "claim of right" doctrine, the bailment contention will not serve as a bar. *United States v. Iozia*, 104 F. Supp. 846 (S.D. N.Y.).

Taxpayer's remaining contention (Br. 11-22) amounts, at most, to nothing more than an inconclusive attempt to obviate the clear applicability of the "claim of right" doctrine to the established facts here obtaining. Point II (a) (Br. 11-13) contributes nothing to advance taxpayer's general contentions. On the contrary, the utter failure to relate the discussion to the facts here obtaining deprives the argument of all force whatsoever. To the extent that tax-

payer exclusively emphasizes (Br. 11) the criterion of *when* income becomes taxable the focus is erroneously directed away from the here pertinent consideration that the "claim of right" rule becomes operative, under the instant facts, to product a realization of income in the year of taxpayer's receipt of the sales proceeds without restriction as to use. Clearly, this absence of restriction at the time of receipt, in 1951, is sufficient to make the rule operative, with the result that the sales proceeds are properly includible in gross income at that time. The correctness of this proposition is understood when attention is directed to the equally fallacious argument advanced by the taxpayer in Point II (c) (Br. 20-22) with respect to an alleged debtor-creditor relationship (Br. 20). Unlike the situation of a loan or a security deposit, the parties to the alleged promotional services agreement (R. 20) are in juxtaposition here with respect to raising a debtor-creditor analogy. Raichart had never advanced anything to the taxpayer which could have served to impose a use restriction on the stock sales proceeds when received by the taxpayer in 1951. Whereas the taxpayer relies upon the alleged breach (Br. 14), all that had been created by that agreement was, at most, a contractual relationship, which would not serve to prevent the applicability of the "claim of right" doctrine. As the court stated in *St. Regis Paper Co. v. Higgins*, *supra*, with respect to the dividends there in issue (p. 885):

Their declaration violated no law and at most their payment was the breach of a private con-

tract and the recipient was not without all semblance of right and title to them as was the embezzler in *Commissioner v. Wilcox*, 327 U.S. 404, 66 S. Ct. 546.

For purposes of taxability to the taxpayer in 1951, the fact that the contractual obligation ultimately proved enforceable is here irrelevant, and, in such circumstance, the taxpayer would, of course, become entitled to a deduction in the year of payment. What is relevant, for present purposes, is that the taxpayer actually did receive the sales proceeds without restriction in 1951 and treated them as his own and when a later claim was asserted by Raichart's estate he denied such claim and vigorously opposed it in the state courts. At no time, until appeal was finally denied did he recognize the claim's validity. In point of fact all that he ever recognized was the validity of the adverse judgment.

Point II (b) of taxpayer's argument (Br. 13-19), amounts essentially to a denial (Br. 14, 19) of any bona fide claim of right. But see *Rutkin v. United States*, *supra*. In making the contention the taxpayer basically alleges (Br. 14) the breach of the written agreement, which, as we have pointed out above, has, under the facts here established, no controlling effect. What is pertinent is that, at the time of the 1951 sale, the taxpayer received the sales proceeds, under a claim of right without restriction as to their immediate use. As between the California Corporation Commissioner and the taxpayer, no lawful restriction was further imposed when the shares were released from escrow. As between Raichart's

estate and the taxpayer, absent the assertion of any claim at the time of sale, the existence of an earlier executed private contract, which might or might not be raised and, if so, enforced, did not serve as a restriction upon immediate use. In point of fact, the taxpayer did receive the sales proceeds as his own and, subsequently, when the alleged breach was raised, did assert his claim to the proceeds in the courts. Not until the adverse judgment was rendered against him, in 1953, with appeal being denied, did he abandon his claim. Only in the sense that any losing litigant's claim, no matter how vigorously asserted, can be said to lack bona fides can it be said that the taxpayer's present contention has any validity and, to assert this proposition, would be to deny the operative effect of the claim of right doctrine altogether. Cf. *United States v. Lewis*, 340 U.S. 590, 592. Finally, the taxpayer's assertion of an equitable defense (Br. 14) is of no avail. As the Supreme Court majority stated in the *Lewis* case, *supra* (p. 592):

The "claim of right" interpretation of the tax laws has long been used to give finality to that [annual account] period, and is now deeply rooted in the federal tax system. * * * We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.

CONCLUSION

The decisions of the Tax Court should be affirmed.

Respectfully submitted,

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AUGUST, 1958.

No. 15890

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

N. GORDON PHILLIPS and LAURETTA M. PHILLIPS,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF OF THE PETITIONERS.

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FILED

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PAUL P. O'BRIEN, CLERK

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N. GORDON PHILLIPS and LAURETTA M. PHILLIPS,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF OF THE PETITIONERS.

ARGUMENT.

I.

The Tax Court Erred in Entering Separate Decisions
Against Each Petitioner for the Full Amount of
the Asserted Deficiency for the Calendar Year
1951.

Respondent at the conclusion of its brief states that the decisions of the Tax Court should be affirmed. Regardless of the merits of this case, and assuming this Court were to agree with the opinion of the Tax Court, the decisions entered therein should none the less be modified.

Petitioners filed a joint federal income tax return for the year 1951. There should have been only one petition filed in the Tax Court. However, separate petitions were filed for the husband and for the wife. The Tax Court,

having decided in favor of the Respondent thereupon entered a separate judgment in each proceeding in the full amount of the deficiency, to-wit, \$15,525.59.

Obviously the agents of the Commissioner of Internal Revenue, having two separate judgments for \$15,525.59 each, will be obligated to collect the full amount of each judgment, or a total of \$31,051.18, unless the order is modified. No appeal bond was filed in this proceeding, and counsel has been advised that collection agents have been attempting to collect the full amount of the deficiency from each spouse. If the opinion of the Tax Court were to be adopted, the decision of that Court should be modified to provide for a single judgment against both taxpayers for the amount of such deficiency.

II.

The Tax Court Erred in Holding Taxpayer Received the Proceeds of Sale of the Stock Without Restriction as to the Disposition of the Proceeds.

Respondent has failed to refute the arguments of taxpayers that the sales proceeds received in 1951 were received subject to a contractual restriction. In this case taxpayer, prior to the sale in question, had entered into an agreement with Raichart to the effect that 320 of the shares sold were owned by him. This agreement, although contested by taxpayers, was at all times in full force and effect and was upheld in the California courts. As a condition precedent to his right to the sales proceeds, taxpayer was required to invalidate this agreement. He was unable to do so. The cases cited by Respondent (Br. 11) all involve what might be referred to as conditions subsequent. In *North American Oil v. Burnet*, 286 U. S. 417, the money was paid over to the taxpayer by the

receiver pursuant to the judgment of the lower court. It properly belonged to the taxpayer at that point, subject only to a possible reversal of the decision upon appeal. For the year in question it had been held by the court that the taxpayer was entitled to the money. The same was true in *Phillips v. Commissioner*, 25 T. C. 767, affirmed 238 F. 2d 473 (C. A. 7th), which involved a contingent fee. He won the case in the lower court and received his fee. Later the decision was reversed, and the attorney was forced to return the fee. In *Rutkin v. United States*, 343 U. S. 130, the extorted money was never returned at all, nor was there any inference that it ever would have been. This argument was raised by the taxpayer merely by way of a possible defense in his tax case.

In the case before this Court the taxpayer by contract had agreed that the 320 shares of stock belonged to Raichart. The proceeds received on their sale likewise belonged to him. It is true that taxpayer endeavored to avoid the contract, but to no avail. If A borrows money from B he does not realize income upon the receipt of the loan because of his obligation to repay. A may of course breach his agreement and refuse to repay. However, counsel knows of no case holding that A realizes income merely as a result of such breach. He may of course realize income if B forgives the debt or fails to enforce his rights within the applicable period of limitations. Here, however, the executrix of Raichart's estate instituted prompt legal action to enforce the contract [Resp. Exs. D and F].

In *St. Regis Paper Co. v. Higgins*, 157 F. 2d 884, cited by Respondent (Br. 15) a corporation received dividends from its wholly owned subsidiary and paid tax thereon. The dividend was later rescinded and the money

repaid to the subsidiary because the dividend was in violation of an indenture agreement. However, there was nothing illegal about the dividend. The declaration and payment merely gave the indenture trustee the express remedy of acceleration of the payment of principal and interest on debentures covered by the agreement. By way of dictum the court stated that assuming the taxpayer could have been held liable as a constructive trustee, the declaration of the dividend violated no law and at most the payment was the breach of a private contract. In the case before this Court the taxpayer wrongfully converted the property of another. Conversion involves a tortious act—some act of ownership or exercise of dominion over the property of another in defiance of his rights.

Similarly in *United States v. Lesoine*, 203 F. 2d 123, also cited by Respondent (Br. 15) and decided by this Court, involved dividends paid in one year to the two stockholders of a California corporation with the dividend being rescinded in the following year. The corporation had no book surplus at the time the dividends were paid, but it did have “earnings or profits” for payment of dividends within the meaning of Section 115(a) of the Internal Revenue Code of 1939. These earnings remained intact and were available for the distribution of the dividends in question.

III.

The Tax Court Erred in Not Taxing the Gain Realized on the Sale of the Stock to the Owner Thereof as Determined by the State Court in an Adversary Proceeding.

Respondent has not been able satisfactorily to distinguish *Estate of Bluestein v. Commissioner*, 15 T. C. 770 from the facts of this case. It will not suffice merely to point out that estate tax as well as income tax was there involved (Br. 13-14), nor merely to state that *Freuler v. Helvering*, 291 U. S. 35, controlled the includibility of assets in the estate. The fact remains that the decedent had claimed the income from property owned by others as his own up to the time of his death. The judgment of the state court determining property interests was entered in the year following death. Respondent maintains that no events that occur subsequent to the accounting year can ever be accorded any recognition in a case such as this. Yet the Tax Court in *Bluestein* did in fact tax the income to the owner of the property on the basis of the subsequent determination.

Respondent cites *United States v. Lewis*, 340 U. S. 590 (Br. 14), for the proposition that the "claim of right" doctrine has not been impaired by *Freuler v. Helvering*, 291 U. S. 35, as stated by the Court of Claims. Counsel does not contend to the contrary. Nevertheless, in that case (91 Fed. Supp. 1017) the Court stated at page 1021:

"* * * The fact that the court so interpreted the statute [in *Freuler v. Helvering, supra*] as to make taxability depend upon the outcome of litigation as to whether the beneficiaries actually receiving the income were legally entitled to keep it or not seems to us to discount very heavily the idea that the finances

of the nation would be thrown into disorder if the Government were allowed to tax as income only that which is, in fact, income to the taxpayer, and not that which only seems to be income because he is mistaken as to his right to keep it.”

Evidently Congress also felt that the nation’s finances could survive without the necessity of applying the unnecessarily harsh and inflexible mechanical rule enunciated in the *Lewis* case. See Section 1341 of the Internal Revenue Code of 1954.

The doctrine of the *Lewis* case should not be applied to the case before this Court unless it appears that the facts bring it squarely within that rule. It is submitted that they do not. The *Lewis* case involved the question whether a bonus should be computed on net profits before or after deduction of taxes. This case involves the wrongful conversion of the property of another and is much more similar to the facts of the *Bluestein* case than to those of the *Lewis* case.

IV.

All Relevant Facts and Circumstances Must be Considered.

Without repeating the arguments under this heading in petitioners’ opening brief, it should none the less be pointed out that cases such as *United States v. Iozia*, 104 Fed. Supp. 846, cited by Respondent (Br. 15) involve prosecution for the filing of false and fraudulent returns. The defense in each instance is that the money in question does not represent income because stolen from another. This was also substantially the situation in *Rutkin v. United States*, 343 U. S. 130. Obviously the Courts, confronted with such a factual situation, are

going to limit the rule of *Commissioner v. Wilcox*, 327 U. S. 404, to a clear case of no realizable gain. To do otherwise would make crime pay with a vengeance.

In the case here before this Court, however, the situation is entirely different. Taxpayer paid the tax on the entire gain realized on the sale of all the stock in 1951. The tax was paid not only on the gain attributable to taxpayers' stock but also on the stock owned by another. Tax presumably has also been collected from the owner of that stock. The Treasury is not being asked to assess the relative merits of the respective claims of the two owners or to withhold the collection of any tax pending the outcome of litigation. All that is here in issue is the correct amount of tax owed by petitioners for the calendar year 1951. The correct amount of capital gain which should be taxed is the gain on the stock owned by these taxpayers exclusive of the gain realized on the stock owned by a third party as determined by the California courts. This Court is asked to so hold.

CONCLUSION.

The decisions of the Tax Court should be reversed. If not reversed, they should be modified as to provide for one joint and several judgment in the amount of the deficiency rather than two separate judgments, each in the full amount of the deficiency.

Respectfully submitted,

A. L. BURFORD, JR.,

Attorney for Petitioners.

No. 15891 ✓

United States
Court of Appeals
for the Ninth Circuit

BERNARD KIRSCH,

Appellant.

vs.

GEORGE BARNES, MILTON L. HUBER, G.
EDWARD GOODWIN, MILTON L. HUBER
& G. EDWARD GOODWIN, a Copartnership
Doing Business as Huber & Goodwin,

Appellees.

Transcript of Record

Appeal from the United States District Court for the
Northern District of California,
Northern Division.

FILED

MAR 12 1958

PAUL P. O'BRIEN; CLERK

No. 15891

United States
Court of Appeals
for the Ninth Circuit

BERNARD KIRSCH,

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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In the District Court of the United States for the
Northern District of California, Northern
Division

No. 36020

BERNARD KIRSCH,

Plaintiff,

vs.

GEORGE BARNES, MILTON L. HUBER, G.
EDWARD GOODWIN, MILTON L. HUBER
& G. EDWARD GOODWIN, a Copartnership,
Doing Business as HUBER & GOODWIN,

Defendants.

COMPLAINT FOR MONEY

Comes now plaintiff and for cause of action
against defendants herein alleges:

I.

At the time of the filing of the complaint herein
plaintiff was and at all times herein mentioned has
been and still is a resident of the State of New
York.

II.

At the time of the filing of the complaint herein
defendants were and at all times herein mentioned
have been citizens and residents of the State of
California, and of the Northern Division of the
Northern District thereof.

III.

This is an action by citizens of different states, viz., the plaintiff on one side and the defendants on the other side, and the amount in controversy is in excess of Ten Thousand Dollars (\$10,000.00).

IV.

Milton L. Huber and G. Edward Goodwin are now and at all times herein mentioned have been attorneys and copartners doing business as Huber & Goodwin. During several years up to and including October 16, 1952, Huber & Goodwin were the regularly retained and employed attorneys for plaintiff.

V.

Dayton C. Murray, Jr., hereinafter called Murray, was on July 26, 1951, duly appointed a Notary Public in and for the County of Humboldt, State of California, for the term of four (4) years from the date of said commission and was until the termination of said commission a duly acting and appointed Notary Public. Said Dayton G. Murray, Jr., is now and at all times herein mentioned has been an attorney at law, employed by Defendants Huber & Goodwin.

VI.

At all times mentioned herein and until the 29th day of June, 1956, plaintiff herein was the owner of certain timber located in the County of Humboldt, State of California.

VII.

On or about October 23, 1952, under the circumstances hereinafter set forth, and without the knowledge and consent of plaintiff, said Murray, in his capacity as Notary Public, wilfully and wrongfully signed and sealed a certificate of acknowledgment of the signature of plaintiff to a contract dated October 16, 1952, between plaintiff, Huber & Goodwin, a partnership, and George Barnes, and affixed said certificate to said contract. Said certificate of acknowledgment bore the date of October 16, 1952. A copy of said contract, together with said certificate of acknowledgment is attached hereto marked Exhibit "A" and made a part hereof. The timber described in said contract is the same timber as that mentioned in Paragraph III above. Plaintiff did not acknowledge his signature to said contract and said certificate of acknowledgment was false.

Plaintiff did not discover that said certificate had been falsely made and attached to said contract until the occurrence of the events hereinafter set forth.

Said false certificate was attached to said contract under the following circumstances:

On or about said 23rd day of October, 1953, Defendant Barnes and a secretary employed by Huber & Goodwin, acting in the course and scope of her employment as such, procured said Murray to affix

said certificate of acknowledgment of signature of plaintiff to said contract. Said certificate was attached by said Murray to said contract in the course and scope of his employment by Defendants Huber & Goodwin.

VIII.

On many occasions during the years immediately prior to October 16, 1952, documents were prepared by Huber & Goodwin as attorneys for plaintiff which were signed by plaintiff in the offices of Huber & Goodwin and from time to time to some of said documents notarial certificates of acknowledgment were affixed. Plaintiff relied on Huber & Goodwin to comply with whatever conditions were necessary for the purpose of such certificates and to affix such certificates only when essential to the efficacy of the document concerned.

Said contract of October 16, 1952, was prepared by said Goodwin in his capacity as attorney for plaintiff. It is and at all times herein mentioned has been the recollection of plaintiff that said contract was signed by him in the offices of Huber & Goodwin.

On January 30, 1956, an action involving said contract of October 16, 1952, in which Bernard Kirsch was the plaintiff and said Huber & Goodwin and Barnes were defendants came on for trial in the United States District Court at Sacramento, California.

At said trial plaintiff testified that he had signed said contract in the offices of Huber & Goodwin in Eureka.

On February 1, 1956, said Goodwin testified that said contract was signed by plaintiff at plaintiff's place of business in Blue Lake, Humboldt County, which is approximately fourteen miles from Eureka, in the afternoon of October 16, 1952. Said Goodwin further testified that the only persons present were himself and Kirsch, and that Murray did not accompany him on said occasion. Goodwin further testified that he had no recollection of the acknowledgment of said contract by plaintiff, Barnes or himself.

On February 7, 1956, said Barnes testified in said action that he signed the contract on the morning of October 16, 1952, in the offices of Huber & Goodwin and that plaintiff was not present when he did so. Barnes further testified that on October 23, 1952, at the office of Huber & Goodwin in Eureka, California, Barnes and an employee of Huber & Goodwin in Eureka, California, procured said Murray to affix to said contract a notarial certificate of acknowledgment certifying that on said date Kirsch and Barnes acknowledged to Murray that they executed said contract.

On said February 8, 1956, pursuant to subpoena obtained by plaintiff, following the testimony of Goodwin on February 1, 1956, as aforesaid, said Murray appeared as a witness in said trial. He tes-

tified that he had no recollection of any acknowledgment by plaintiff of his execution of said contract, and further testified that he did not maintain a record of his notarial acts in accordance with Section 8206 of the Government Code of California.

IX.

Thereafter on September 11, 1953, said Barnes, without the knowledge or consent of plaintiff, recorded said contract in the official records of the Office of the Recorder of the County of Humboldt, and was able to and did thereby cause a cloud to be cast on plaintiff's title to the timber described in said contract, to the damage of plaintiff, as hereinafter set forth.

X.

At the time of said recordation, negotiations were pending for the sale by plaintiff to the State of California of a portion of the timber described in said contract for the price of \$287,500.00. On the 28th day of April, 1954, plaintiff deposited in escrow a grant deed conveying to the State of California the interest of plaintiff in said portion of the timber. On the 27th day of July, 1954, the State of California deposited in escrow warrants in the total sums of \$287,500.00, as the price of said timber and required as a condition precedent to the consummation of said transaction the issuance of a policy insuring the title of the State to said timber free and clear of encumbrances.

XI.

As a direct and proximate result of the false acknowledgement affixed to said contract of October 16, 1952, and the recordation thereof, a cloud was cast on plaintiff's title to said timber as aforesaid. No such policy of title insurance, required by the State of California as aforesaid, could be obtained and consequently it was impossible to consummate said sale until June 29, 1956, under the circumstances hereinafter set forth.

XII.

Upon ascertaining the facts hereinabove set forth, plaintiff made continuous and diligent efforts to procure the consummation of said sale to the State of California and in order to do so it was necessary for plaintiff to enter into an agreement providing for the withholding of the sum of \$80,000.00 for the account of said Barnes to provide for the payment of any claim which Barnes might thereafter establish for damages recovered against plaintiff under said contract, and the sum of \$45,000.00 for the account of Huber & Goodwin for similar purposes. Said agreement also provided for the removal from the title to said timber of the cloud created by the recordation of said contract by means of quitclaim deeds to the State of California. Plaintiff was unable to complete said transaction until June 29, 1956, and on said date said sale was consummated and the purchase price of said timber was paid, and of said purchase price the amounts hereinabove stated were withheld and are still withheld for the purposes above set forth.

XIII.

During the period of delay in the consummation of said sale plaintiff received no income from said timber. If plaintiff had received the purchase price on July 27, 1954, he could and would have invested the same and procured a substantial income therefrom.

As a direct and proximate result of said false acknowledgment and the recordation of said contract bearing said false acknowledgment, and the resulting delay in the consummation of the sale of said timber to the State of California, as set forth hereinabove, plaintiff has been damaged in that he has incurred liability for and has paid taxes on said timber which would not otherwise have been incurred, to wit:

Fiscal Year	Amount
July 1, 1954, to June 30, 1955.....	\$1,189.57
July 1, 1955, to June 30, 1956.....	1,977.03
<hr/>	
Total	\$3,166.60

and in addition thereto the Tax Collector of Humboldt County has made demand on plaintiff for taxes on a portion of said timber in the sum of \$501.74.

Wherefore, plaintiff prays judgment against defendants and each of them in the sum of \$38,936.00, with interest thereon from July 3, 1956, at the rate of 7% per annum; the sum of \$1,189.57, with interest thereon from July 28, 1955, at said rate;

the sum of \$1,977.03, with interest thereon from October 31, 1956, at said rate; the sum of \$501.74; together with costs of suit and such other and further relief as may be proper in the premises.

DAVID LIVINGSTON,
HAROLD R. FARROW,
JAMES R. MANSFIELD,

By /s/ DAVID LIVINGSTON,
Attorneys for Plaintiff.

EXHIBIT A

Agreement

This Agreement made this 16th day of October, 1952, by and between Bernard Kirsch (hereinafter referred to as Kirsch), as First Party, and George Barnes (hereinafter referred to as Barnes), as Second Party, and Huber & Goodwin as Third Party.

Witnesseth

Whereas, Kirsch is the owner of certain redwood, fir and spruce timber, situated north of Orick, Humboldt County, California, and generally known as the Prairie Creek timber, and desires to log the same; and

Whereas, Barnes is experienced in forestry and logging and is capable of causing the said timber to be logged; and

Whereas, Huber & Goodwin are able to prepare all agreements required, collect and disperse the forthcoming proceeds, and so forth; and

Whereas, the parties hereto desire by this agreement to define the respective rights and privileges each to the other:

It Is Now Therefore Agreed as Follows:

1. Kirsch agrees to permit the Prairie Creek timber aforesaid to be logged, commencing immediately, and as rapidly as good forestry practices and market conditions permit. Barnes shall be, and he is hereby designated the General Manager for the purpose of causing the said timber to be logged economically, including the logging, relogging, and making of split products thereon as economies permit. Barnes agrees to immediately enter upon his duties, take full charge of the operations and cause the premises to be logged, devoting all time reasonably necessary to conduct the operations necessary in accordance with the best logging practices and so as to effect the best recovery therefrom. In this regard, Barnes shall exercise his discretion in the employment of or contracting with loggers or logging subcontractors, truckers or any other men, machinery or equipment required to perform the services.

2. All logs developed from the property shall be delivered to such sawmill or other consumer as Barnes may from time to time select, at the maximum price which Barnes is able to obtain therefor.

Payment for all logs shall be made directly from the purchaser thereof to Huber & Goodwin, Attorneys at Law, 537 "G" Street, Eureka, California.

3. Huber & Goodwin agree to receive and collect all said funds, as Trustees, and to disperse the same according to the following plan:

(a) To promptly pay, when due, all logging costs and expenses pursuant to invoices submitted to the said Huber & Goodwin by the loggers, logging sub-contractors, truckers, etc., and which said invoices shall first be approved and authorized for payment by Barnes;

(b) To pay to Kirsch for all logs sold the sum of \$8.50 per M feet, payment to be on the basis of Humboldt log scale for redwood logs and Spaulding scale for fir and spruce logs;

(c) To repay to Kirsch any sums of money advanced by Kirsch from and after October 15, 1952, for tractor work, road work, or any other expenses assumed and paid by Kirsch in preparing the property for logging;

(d) In addition to the foregoing sums, to pay to Kirsch the sum of \$6.00 per M feet, Humboldt scale, for all felled, bucked, and peeled redwood or other logs now upon the aforesaid premises;

(e) All remaining sums, if any there be, shall be paid and distributed between the parties hereto by said Huber & Goodwin, as follows: (1) to Kirsch—37½% thereof; (ii) to Barnes—37½% thereof; and (iii) to Huber & Goodwin—25% thereof.

In this regard, the parties agree that they will at all times, and until the termination of this agreement, maintain with said Huber & Goodwin a reasonable balance of receipts over disbursements, so as to provide for unanticipated expenses. Huber & Goodwin agree that they will currently, during the life of this agreement, and not less frequently less than once a month, account to Kirsch and Barnes for all receipts and disbursements.

4. With reference to sub-section b of Section 3 hereof, wherein it is agreed that Kirsch shall be paid \$8.50 per M feet before making further distribution, the parties stipulate that said sum is not intended to represent the fair market value of said timber and that the fair market value of said timber as of the date hereof is agreed to be \$15.00 per M net scale. It is the intention of the parties that the participants herein shall share in the capital gain between said \$8.50 figure and said \$15.00 figure, as their interest may appear.

5. It is agreed that there is a period of removal of said timber, expiring on May 4, 1958, and Barnes agrees to so conduct the operation so that all merchantable timber will be removed from the premises before said date.

In Witness Whereof, the parties hereto have hereunto set their hands the day and year in this agreement first hereinabove written.

/s/ BERNARD KIRSCH,
First Party.

/s/ GEORGE BARNES,
Second Party.

HUBER & GOODWIN,
/s/ G. E. GOODWIN,
Third Party.

Acknowledgment—General

State of California,
County of Humboldt—ss.

On this 16th day of October, A.D. 1952, before me, Dayton D. Murray, Jr., a Notary Public in and for the said County and State, residing therein, duly commissioned and sworn, personally appeared Bernard Kirsch and George Barnes, known to me to be the persons whose names are subscribed to the within Instrument, and acknowledged to me that he executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my official seal the day and year in this Certificate first above written.

[Seal] DAYTON D. MURRAY, JR.,
Notary Public in and for Said County and State
of California.

My Commission Expires July 26, 1955.

Partnership Acknowledgment

State of California,
County of Humboldt—ss.

On this 16th day of October in the year one thousand nine hundred and fifty-two, before me Dayton D. Murray, Jr., a Notary Public in and for the said County and State, residing therein, duly commissioned and sworn, personally appeared G. E. Goodwin, known to me to be one of the partners of the partnership that executed the within instrument, and acknowledged to me that such partnership executed the same.

In Witness Whereof I have hereunto set my hand and affixed my official seal, in and for the said County and State, the day and year in this certificate first above written.

[Seal] DAYTON D. MURRAY, JR.,
Notary Public in and for the Said County and
State of California.

My Commission Expires July 26, 1955.

11449

Recorded at Request of

George Barnes.

Vol. 263 Official Records Pg. 336.

Sept 11, 8:40 a.m., '53.

Humboldt County Record.

Emma Cox Acala, Recorder.

Callan Parker, Deputy.

Fee \$2.50.

Mail to:

George Barnes,
3021 Fairfield,
Eureka, Calif.

Compared: Bernice Starr, Comparer.

[Endorsed]: Filed November 30, 1956.

[Title of District Court and Cause.]

MOTION TO DISMISS ACTION FOR FAIL-
URE TO STATE A CLAIM FOR WHICH
RELIEF CAN BE GRANTED

Comes now the Defendant George Barnes, and moves the court for its order dismissing the Complaint on file herein, and for its order awarding defendant attorney's fees and costs.

This motion is based upon the ground that said Complaint fails to state a claim upon which relief can be granted, and upon the further ground that it appears from the face of said Complaint that plaintiff's claim is barred by reason of the statute of limitations of the State of California.

Dated: This 16th day of January, 1957.

HILL & HILL,

By /s/ W. G. WATSON, JR.,

Attorneys for George Barnes.

[Title of District Court and Cause.]

NOTICE OF MOTION

To Bernard Kirsch, and to Messrs. David Livingston, Harold R. Farrow, James R. Mansfield,
His Attorneys

You, and Each of You, Will Please Take Notice and Are Hereby Notified that on the 4th day of February, 1957, at 10:00 o'clock a.m., of said day, or as soon thereafter as counsel can be heard by the above-entitled Court, located at the United States Post Office and Court House, Sacramento, California, defendant, George Barnes, will move the Court to dismiss the Complaint on file herein on the ground set forth in the Motion filed herewith, and for its order awarding defendant attorney's fees and costs.

Dated this 16th day of January, 1957.

HILL & HILL,

By /s/ W. G. WATSON, JR.,
Attorneys for Defendant,
George Barnes.

Affidavit of Service by Mail Attached.

[Endorsed]: Filed January 16, 1957.

[Title of District Court and Cause.]

MOTION TO DISMISS ACTION FOR FAILURE TO STATE A CLAIM ON WHICH RELIEF CAN BE GRANTED

Come now Defendants Milton L. Huber, G. Edward Goodwin, Milton L. Huber & G. Edward Goodwin, a copartnership, doing business as Huber & Goodwin, and move the court for its order dismissing the Complaint on file herein, and for its order awarding defendants attorney's fees and costs.

This motion is based upon the ground that said Complaint fails to state a claim upon which relief can be granted, and upon the further ground that it appears from the face of said Complaint that plaintiff's claim is barred by reason of the statute of limitations of the State of California.

Dated: This 16th day of January, 1957.

/s/ PHILIP C. WILKINS,
Attorney for Defendants Milton L. Huber and G.
Edward Goodwin.

[Title of District Court and Cause.]

NOTICE OF MOTION

To Bernard Kirsch, and to Messrs. David Livingston, Harold R. Farrow, James R. Mansfield,
His Attorneys

You, and Each of You, Will Please Take Notice and Are Hereby Notified that on the 4th day February, 1957, at 10:00 o'clock a.m. of said day, or as soon thereafter as counsel can be heard by the above-entitled court, located at the United States Post Office and Court House, Sacramento, California, Defendants Milton L. Huber, G. Edward Goodwin, Milton L. Huber & G. Edward Goodwin, a copartnership doing business as Huber & Goodwin, will move the court to dismiss the Complaint on file herein on the grounds set forth in the Motion filed herewith, and to award defendants attorney's fees and costs.

Dated: This 16th day of January, 1957.

/s/ PHILIP C. WILKINS,
Attorney for Defendants Milton L. Huber and G.
Edward Goodwin.

Affidavit of Service by Mail attached.

[Endorsed]: Filed January 16, 1957.

In the United States District Court for the
Northern District of California, Northern Division
Civil No. 7477

BERNARD KIRSCH,

Plaintiff,

vs.

GEORGE BARNES, MILTON L. HUBER, G.
EDWARD GOODWIN, MILTON L. HUBER
& G. EDWARD GOODWIN, a Copartnership,
Doing Business as HUBER & GOODWIN,

Defendants.

MEMORANDUM AND ORDER

Plaintiff, a citizen and resident of the State of New York, has filed in this Court a complaint, which he asserts states a cause of action for slander to title, against the defendants, citizens and residents of the State of California. There being proper allegations of jurisdictional amount, the action appears to be within the jurisdiction of this Court.

Defendants have each filed a motion to dismiss the complaint on the ground that the complaint fails to state a claim upon which relief can be granted. They, in essence, contend that facts necessary to ground a claim for slander to title have not been plead, and even if such facts were alleged, the action would be barred by the applicable (California) statute of limitations.¹

¹The statute of limitations as a defense is not pressed by the defendants, and in view of the conclusions reached herein, the Court has not deemed it necessary to reach this issue at this time.

It is a principal too well established to require the citation of much authority that a complaint should not be dismissed on the ground that it fails to state a cause of action "unless it appears to a certainty that plaintiff is entitled to no relief under any state of facts which could be proved in support of the claim" (2 Moore, Federal Practice, para. 12.08). This rule requires a close examination of the facts plead in the light most favorable to the pleader.

On October 16, 1952, plaintiff entered into a contract with defendants, whereby plaintiff, the owner of timber rights on a certain parcel of property, gave to defendant, Barnes, the right to log and sell the timber, in consideration of an agreed percentage of the timber sales proceeds. Under the contract, the law partnership of Huber & Goodwin became obligated to administer the funds derived from the contract and to handle all legal matters related thereto, in consideration of an agreed percentage of the timber sales proceeds. On October 23, 1952, Dayton C. Murray, Jr., a notary public in and for the County of Humboldt, State of California, employed in the offices of Huber & Goodwin, executed a notary's certificate of acknowledgment of the signatures of plaintiff and defendant, Barnes, and affixed the same to the contract.² The certificate of

²There is also attached to the instrument a separate notary's certificate of acknowledgment for the partnership of Huber & Goodwin, which is, as noted above, one of the parties to the agreement.

acknowledgment is alleged to be false, in that plaintiff was not present when it was prepared and executed. Plaintiff does not assert that the contract was in any way invalid or that he failed to affix his signature to the contract. Plaintiff merely alleges that defendant, Barnes, induced Murray to prepare and execute a notarial certificate of acknowledgment in plaintiff's absence, thereby rendering it false. Having procured the certificate of acknowledgment, Barnes thereafter, unbeknownst to plaintiff, on September 11, 1953, filed the contract of record. During this period, plaintiff was negotiating with the State of California for the sale of his timber rights, some of which formed the subject matter of the prior Barnes contract. On July 27, 1954, preliminary negotiations having been completed, plaintiff deposited in escrow a grant deed to the State of California, and the State of California deposited therein warrants in the amounts of \$287,500 pending the issuance of a policy of title insurance. Due to the recordation of the contract, and the acknowledgment (false as to the plaintiff), affixed thereto, no title policy could be obtained, and the sale by plaintiff to the State of California was delayed until June 29, 1956. Presumably, sometime between July 27, 1954, and June 29, 1956, plaintiff discovered the fact of recordation, and in an effort to consummate the ultimate sale to the State of California, procured alterations in the agreement with the State of California providing for the withholding of \$80,000 of the purchase price by the state in favor of Barnes, and \$45,000 in favor of Huber

& Goodwin. As a further provision of the altered agreement with the state, quitclaim deeds by the various parties to the Barnes contract were required to be made to the State of California. The completion date of the aforementioned transaction was June 29, 1956. Plaintiff contends that he suffered damage by virtue of the delay in consummating the sale to the State of California, which delay, he asserts, was directly and proximately caused by the placing of record of the Barnes contract, which recordation, plaintiff alleges, could not have taken place, but for the false notarial certificate of acknowledgment.³ Damages are listed as the additional taxes and assessments levied against plaintiff's property during the period of delay, and the loss of the earning capacity of the funds which would have been obtained for the sale had it been consummated in 1954, as originally contemplated.

In view of the record here, this case must be, and it will be, decided on the basis of the certificate of acknowledgment which plaintiff asserts is, as to him, false. For the purpose of the order to be made, this will be assumed to be a fact, and no consideration will be given to the other forms of acknowledgment attached to the contract.

³Plaintiff has not asserted that the Barnes certificate of acknowledgment or the Huber & Goodwin certificate of acknowledgment, or either of them is false, and no one has considered the effect of these certificates of acknowledgment, if in fact either one or both of them are legal and proper.

Certain fundamental rules relating to acknowledgments and recordation should be noted before proceeding to an examination of plaintiff's theory of his case. Under California law, an acknowledgment certified by a notary is a prerequisite to the recordation of the underlying instrument (Government Code, § 27286). A defectively acknowledged instrument, though not being entitled to record, and thus not capable of imparting constructive notice, is valid as between the parties to the instrument, and all those having actual notice of its existence (*Parkside Realty Co. vs. McDonald*, 166 Cal. 426, 431; *Kimbrow vs. Kimbro*, 199 Cal. 344, 349; and *Johndrow vs. Thomas*, 31 Cal. 2d 202, 206). It has been stated that, "the acknowledgment of a deed is not essential to its validity. The acknowledgment of a deed is merely evidentiary in character and is required only to entitle it to be recorded so as to render it competent evidence of the conveyance without further proof" (*Osterberg vs. Osterberg*, 68 Cal. App. 2d 254, 262. See also: *Williston vs. City of Yuba City*, 1 Cal. App. 2d 166, 171). Where a loss is sustained by reason of a false certificate of acknowledgment of a forged instrument the measure of damages recoverable for such official misconduct by the notary is determined by the evaluation of the rights which would have accrued to the injured party had the underlying instrument been valid (*Heidt vs. Minor*, 113 Cal. 385; facts set forth at 89 Cal. 115). The clear implication from this rule is that there could be no recovery against the notary or his surety for his official misconduct in ex-

ecuting a false acknowledgment where the underlying instrument is valid, for no measurable damages would result therefrom (See: § 8214, California Government Code).

In adopting the Restatement rule, the California Supreme Court in *Gudger vs. Manton*, 21 Cal. 2d 537, set forth the following definition of slander to title:

“One who, without a privilege to do so, publishes matter which is untrue and disparaging to another’s property in land, chattels or intangible things under such circumstances as would lead a reasonable man to foresee that the conduct of a third person as purchaser or lessee thereof might be determined thereby is liable for pecuniary loss resulting to the other from the impairment of vendibility thus caused.”
(At page 541, citing Rest. Torts, § 624.)

Dean Prosser sets forth five basic elements of the tort as the requirements that:

1. The falsehood must be communicated to a third person;
2. The publication and its disparaging innuendo must be plead and proven;
3. The falsity of the matter must be plead as part of the plaintiff’s cause of action;
4. The publication must have played a material and substantial part in inducing others not to deal with plaintiff; and

5. The plaintiff must have suffered special damage as a result.

(See: Prosser on Torts, 2d Ed., 1955, pp. 764, et. seq.) Aside from the question of privilege (e.g., See: *Albertson vs. Raboff*, 46 Cal. 2d 375), the gravaman of the action is the disparaging "innuendo" or "imputation" of matter that is without legal foundation and hence, false (*Gudger vs. Manton*, supra; *Phillips vs. Glazer*, 94 Cal. App. 2d 673, 677-8; cf.: *Kalajian vs. Nash*, 148 A.C.A. 523, 527-528; Rest. Torts, § 629).

Plaintiff contends that it was the untrue acknowledgment, and not the valid contract, which cast doubt on the plaintiff's title to the property, and thus caused the delay in the sale. Plaintiff must, of necessity, take this position for he had no legally protectible interest which could be disparaged by the publication of the Valid contract. Truth does not disparage (Restatement of Torts, § 634; cf.: *Phillips vs. Glazer*, supra). But in setting forth his claim in this fashion, plaintiff misconceives the role of a certificate of acknowledgment. It, by definition, bears no relation to legal interests in property, but serves only to lend to the document, to which it is affixed, the aura of authenticity. As such, the false certificate of acknowledgment, by itself, could impart no disparaging imputation or innuendo against plaintiff's interests in the timber. To conclude otherwise would be to indulge in a series of tenuous syllogisms unwarranted by the California law.

Furthermore, on the facts alleged by plaintiff, no legally protectible interest was lost by him as a result of defendant's activities. His rights against the defendants were no greater before the certificate of acknowledgment was drafted, or before the recordation of the contract, than they were after. That the defective recordation of the Barnes' contract hastened the discovery by plaintiff's prospective vendee of its existence, is of no aid to plaintiff; all that he lost as a result of such recordation was his power to conceal the existence of the Barnes' contract, which, so far as the record shows, was valid and binding as between the parties to it. This Court cannot see how under any such circumstances a "loss" could be compensible.

It is, Therefore, Ordered that plaintiff's complaint, and the cause of action sought to be set forth therein, be, and the same are, hereby dismissed. Defendants will prepare and lodge with the Clerk of this Court all papers and documents necessary for the final disposition of this matter.

Dated: June 24, 1957.

/s/ SHERRILL HALBERT,
United States District Judge.

[Endorsed]: Filed June 24, 1957.

[Title of District Court and Cause.]

NOTICE OF MOTION FOR LEAVE TO
FILE AMENDED COMPLAINT

To: Defendant George Barnes, and to Messrs. Hill & Hill, His Attorneys; and

To: Defendants Milton L. Huber, G. Edward Goodwin, Milton L. Huber & G. Edward Goodwin, a Copartnership, Doing Business as Huber & Goodwin, and to Philip C. Wilkins, Esq., Their Attorney:

Please Take Notice that on Monday, the 22nd day of July, 1957, at the hour of 10 o'clock a.m. of said day or as soon thereafter as counsel can be heard, in the courtroom of the above-entitled court located at the United State Post Office and Courthouse Building, Sacramento, California, plaintiff will move the above-entitled court for leave to file herein an amended complaint, in the form of the amended complaint on file in the office of the Clerk of the above-entitled court, a copy of which amended complaint was on said date mailed to Messrs. Hill & Hill, attorneys for Defendant George Barnes herein, and to Philip C. Wilkins, Esq., attorney for Defendants Milton L. Huber, G. Edward Goodwin, Milton L. Huber & G. Edward Goodwin, a copartnership, doing business as Huber & Goodwin, herein.

Said motion will be based upon the ground that said amended complaint states a cause of action

against defendants herein, and that the filing of said amended complaint will be in the furtherance of justice. Said motion will be based upon this notice of motion, the Memorandum of Authorities in support thereof attached hereto, said amended complaint heretofore lodged with the Clerk of the above-entitled Court, and the Memorandum of Points and Authorities heretofore filed herein by plaintiff.

Plaintiff hereby requests leave to submit the above-described motion without oral argument and without appearing at the time and place hereinabove specified.

Dated: July 9, 1957.

DAVID LIVINGSTON, et al.,

By /s/ DAVID LIVINGSTON,
Attorneys for Plaintiff.

Memorandum of Authorities

Kelly v. Delaware River Joint Commission, 187 Fed. 2d 93 (Ct. of Ap., 3d Cir.):

Syl. 2. Motion to dismiss complaint is not a "responsive pleading" within federal rule permitting party to amend once as a matter of course at any time before "responsive pleading" is served. Fed. Rules Civ. Proc. Rule 15 (a), 28 U.S.C.A.

Russo v. Sofia Bros., 2 Fed. Rules Dec., 80 (Dist. Ct., S.D.N.Y.):

Syl. 6. Where district judge's memorandum granting codefendant's motion to dismiss complaint as to codefendant for failure to state a cause of action contained no reference to plaintiff's right to plead over, and there had been no trial of issues, and judge signed codefendant's order of dismissal which made no reference to amendment, the judge's action was to be construed as denying a general leave to amend but not as denying plaintiff the privilege of proceeding on proper papers to seek District Court's permission to serve a specific amendment. Federal Rules of Civil Procedure, rules 1, 15(a), 41, 28 U.S.C.A. following section 723c.

Sidebotham v. Robison, 216 Fed. 2d 816 (Ct. of Ap. 9th Cir.):

Syl. 13. In view of means afforded a defendant by Federal Civil Procedure Rules to obtain speedy disposition of a plaintiff's claim without foundation or substance, either by securing more definite statement or bill of particulars and thereafter applying for judgment on pleadings or by moving for summary judgment, dismissal of complaint for insufficiency of statement is not justified, unless it appears to a certainty that plaintiff would be entitled to no relief under any state of facts which could be proved in support of claim. Fed. Rules Civ. Proc. rules 12(e), (h) (1), 56, 28 U.S.C.A.

Certificate of Service attached.

[Endorsed]: Filed July 10, 1957.

[Title of District Court and Cause.]

AMENDED COMPLAINT FOR MONEY

Comes now plaintiff and files this, his amended complaint against defendants and alleges:

I.

At the time of the filing of the complaint herein plaintiff was and at all times herein mentioned has been and still is a resident of the State of New York.

II.

At the time of the filing of the complaint herein defendants were and at all times herein mentioned have been citizens and residents of the State of California, and of the Northern Division of the Northern District thereof.

III.

This is an action by citizens of different states, viz., the plaintiff on one side and the defendants on the other side, and the amount in controversy is in excess of Ten Thousand Dollars (\$10,000.00).

IV.

Milton L. Huber and G. Edward Goodwin are now and at all times herein mentioned have been attorneys and copartners doing business as Huber & Goodwin. During several years up to and including October 16, 1952, Huber & Goodwin were the regularly retained and employed attorneys for plaintiff.

V.

Dayton C. Murray, Jr., hereinafter called Murray, was on July 26, 1951, duly appointed a Notary Public in and for the County of Humboldt, State of California, for the term of four (4) years from the date of said commission and was until the termination of said commission a duly acting and appointed Notary Public. Said Dayton G. Murray, Jr., is now and at all times herein mentioned has been an attorney at law, employed by Defendants Huber & Goodwin.

For several years prior to October 16, 1952, Defendant Barnes had acted in a confidential capacity for plaintiff and procured sales of real property belonging to plaintiff and located in the same vicinity as the timber hereinafter mentioned, and in said transactions Huber & Goodwin had participated in their capacity as attorneys for plaintiff and shared with Barnes in the compensation paid by plaintiff for said services. Prior to October 16, 1952, Barnes had also sought to procure purchasers for the timber mentioned and Huber & Goodwin had participated therein.

VI.

At all times mentioned herein and until the 29th day of June, 1956, plaintiff herein was the owner of certain timber located in the County of Humboldt, State of California.

VII.

On October 16, 1952, Huber & Goodwin, in their capacity as attorneys for plaintiff, prepared and

procured plaintiff's signature to a contract, a copy of which together with the certificate of acknowledgment hereinafter mentioned is attached to the complaint herein, marked Exhibit A and made a part hereof. The timber described in said contract is that mentioned in paragraph III above and was the property of plaintiff and no person other than plaintiff had any right, title or interest therein.

Plaintiff did not acknowledge execution of said contract. Notwithstanding that fact and for the purpose and with the intent of qualifying said contract for recordation as a transaction on the part of plaintiff and thereby producing an apparent encumbrance against plaintiff's title to said timber and placing an obstacle in the way of any transaction on the part of plaintiff with respect to said timber, such as that hereinafter set forth, defendants collaborated with said Murray in order to and did, without the knowledge or consent of plaintiff, procure said Murray, in his capacity as a Notary Public and employee of Huber & Goodwin, and said Murray did in his said capacity and at the instance of defendants wrongfully sign and seal a certificate of acknowledgment of the execution by plaintiff of said contract and affix said certificate to said contract. Said certificate of acknowledgment bore the date of October 16, 1952.

Defendants concealed from plaintiff and plaintiff did not know or discover that said certificate had been falsely made and attached to said contract

until the occurrence of the events in February, 1956, hereinafter set forth.

VIII.

On many occasions during the years immediately prior to October 16, 1952, documents were prepared by Huber & Goodwin as attorneys for plaintiff which were signed by plaintiff in the offices of Huber & Goodwin and from time to time said Huber & Goodwin procured the attachment of notarial certificates of acknowledgment to those documents executed by plaintiff which constituted a conveyance of or creation of a lien or encumbrance upon title to the property. Plaintiff relied on Huber & Goodwin to comply with whatever conditions were necessary for the purpose of such certificates and to affix such certificates only when essential to the efficacy of the document concerned.

Said contract of October 16, 1952, was prepared by said Goodwin in his capacity as attorney for plaintiff. It is and at all times herein mentioned has been the recollection of plaintiff that said contract was signed by him in the offices of Huber & Goodwin.

On January 30, 1956, an action involving said contract of October 16, 1952, in which Bernard Kirsch was the plaintiff and said Huber & Goodwin and Barnes were defendants came on for trial in the United States District Court at Sacramento, California.

At said trial plaintiff testified that he had signed said contract in the offices of Huber & Goodwin in Eureka.

On February 1, 1956, said Goodwin testified that said contract was signed by plaintiff at plaintiff's place of business in Blue Lake, Humboldt County, which is approximately fourteen miles from Eureka, in the afternoon of October 16, 1952. Said Goodwin further testified that the only persons present were himself and Kirsch, and that Murray did not accompany him on said occasion. Goodwin further testified that he had no recollection of the acknowledgment of said contract by plaintiff, Barnes or himself.

On February 7, 1956, said Barnes testified in said action that he signed the contract on the morning of October 16, 1952, in the offices of Huber & Goodwin and that plaintiff was not present when he did so. Barnes further testified that on October 23, 1952, at the office of Huber & Goodwin in Eureka, California, Barnes and an employee of Huber & Goodwin in Eureka, California, procured said Murray to affix to said contract a notarial certificate of acknowledgment certifying that on said date Kirsch and Barnes acknowledged to Murray that they executed said contract.

On said February 8, 1956, pursuant to subpoena obtained by plaintiff, following the testimony of Goodwin on February 1, 1956, as aforesaid, said Murray appeared as a witness in said trial. He

testified that he had no recollection of any acknowledgment by plaintiff of his execution of said contract, and further testified that he did not maintain a record of his notarial acts in accordance with Section 8206 of the Government Code of California.

IX.

On September 11, 1953, negotiations were pending between plaintiff and the State of California for the sale of a portion of said timber to the State. Defendants had knowledge of said negotiations and participated therein. At the time of the execution of said contract on October 16, 1952, defendants had knowledge of the interest of the State in acquiring said timber and of the likelihood that such interest on the part of the State would eventually lead to an offer to purchase said timber.

On September 11, 1953, for the purpose of carrying out the plan devised as aforesaid at the time of the procurement of said false certificate of acknowledgment, of placing on record an apparent encumbrance on the title of plaintiff to said timber, of causing the title insurance company from which insurance on the title to said timber would be required by the State as a condition to the consummation of such sale, to refuse to take the risk as to the effect of said contract of record upon the title of plaintiff, and of preventing the consummation of said sale, said Barnes, without the knowledge or consent of plaintiff, recorded said contract in the official records of the office of the Recorder of the County of Humboldt, to the damage of plaintiff,

as hereinafter set forth. If said certificate of acknowledgment by plaintiff of execution of said contract had not been attached thereto, said Recorder would have refused to record said contract.

Said recordation was concealed from plaintiff and plaintiff proceeded with the negotiations for said sale and in due course deposited in escrow a grant deed conveying the title of plaintiff in said portion of said timber to the State of California and the State of California deposited in escrow its warrants for the purchase price thereof.

X.

As a condition precedent to the consummation of said sale, the State of California required a policy insuring the title of the State to said timber, free and clear of encumbrances. But as the direct and proximate result of said false acknowledgment and recordation of said contract and because of the apparent encumbrance against plaintiff's title to said timber caused thereby, and because the recordation of said contract gave the appearance to said contract of the creation of an interest in defendants to said timber, no policy of title insurance could be obtained, and consequently it was impossible to consummate said sale until June 29, 1956, under the circumstances hereinafter set forth.

Notwithstanding the recordation of said contract, if there had not been attached thereto a certificate of acknowledgment of execution by plaintiff of execution thereof, the title insurance company

would have disregarded said contract and would have issued a policy insuring the record title of said timber as free and clear of any encumbrance insofar as said contract was concerned.

XI.

Upon ascertaining that the State of California refused to consummate said sale for the reasons above stated, plaintiff made continuous and diligent efforts to procure such consummation and in order to do so plaintiff was compelled to enter into an agreement providing for the withholding of the sum of \$80,000.00 for the account of Barnes to provide for the payment of any claim which Barnes might thereafter establish for damages to be recovered against plaintiff because of the alleged violation by plaintiff of said contract, and the sum of \$45,000.00 for the account of Huber & Goodwin for similar purposes. Said agreement also provided for the removal from the title to said timber of the apparent encumbrance created by the recordation of said contract by means of quit claim deeds from defendants to the State of California. Despite plaintiff's efforts to complete said transaction at the earliest possible time as above alleged, plaintiff was unable to do so until June 29, 1956, and on said date said sale was consummated and the purchase price, to wit, \$249,421.28, was paid, and of said purchase price the amounts hereinabove stated were withheld and are still withheld for the purposes set forth.

XII.

During the period of delay in the consummation of said sale plaintiff received no income from said timber. If Plaintiff had received the purchase price on July 27, 1954, he could and would have invested the same and procured a substantial income therefrom. As a direct and proximate result of said false acknowledgment and the recordation of said contract bearing said false acknowledgment, and the resulting delay in the consummation of the sale of said timber to the State of California, as set forth hereinabove, plaintiff has been damaged in that he has been deprived of the amount of the purchase price of said timber from July 27, 1954, to June 29, 1956, and has been deprived of the income which he would have derived from the investment thereof.

As a direct and proximate result of said false acknowledgment and the recordation of said contract bearing said false acknowledgment, and the resulting delay in the consummation of the sale of said timber to the State of California, as set forth hereinabove, plaintiff has been damaged in that he has incurred liability for and has paid taxes on said timber which would not otherwise have been incurred, to wit:

Fiscal Year	Amount
July 1, 1954, to June 30, 1955.....	\$1,189.57
July 1, 1955, to June 30, 1956.....	1,977.03
<hr/>	
Total	\$3,166.60

and in addition thereto the Tax Collector of Humboldt County has made demand on plaintiff for taxes on a portion of said timber in the sum of \$501.74.

Wherefore, plaintiff prays judgment against defendants and each of them in the sum of \$38,936.00, with interest thereon from July 3, 1956, at the rate of 7% per annum; the sum of \$1,189.57, with interest thereon from July 28, 1955, at said rate; the sum of \$1,977.03, with interest thereon from October 31, 1956, at said rate; the sum of \$501.74; together with costs of suit and such other and further relief as may be proper in the premises.

DAVID LIVINGSTON,
HAROLD R. FARROW,
JAMES R. MANSFIELD,

By /s/ DAVID LIVINGSTON,
Attorneys for Plaintiff.

[Endorsed]: Lodged July 5, 1957.

[Title of District Court and Cause.]

MEMORANDUM AND ORDER

This Court by its Memorandum and Order of June 24, 1957 (153 F. Supp. 260), dismissed plaintiff's original complaint and the cause of action sought to be set forth therein. Plaintiff has now filed a motion seeking permission to file an amended complaint in this action.

The facts, which the original complaint alleged to exist, are set forth at length in this Court's earlier Memorandum and Order. The complaint now sought to be filed contains no allegations which materially affect the factual composition as previously set forth. Only the emphasis is shifted. Specifically, the same logging contract, the same parties, the same acts, and the same consequences are involved. Plaintiff's theory of his case has been more clearly defined, however, and, because of that improvement, both the proposed amended complaint and the theory warrant careful analysis.

Preliminarily, there must be a disposition of certain procedural assertions of plaintiff. First, it is not the law that a party may amend his complaint as a matter of right under Rule 15(a), Federal Rules of Civil Procedure, after the Court has entered an order dismissing the original complaint and the cause of action sought to be set forth in it, and this is true even though the "motion to dismiss" is not properly denominated a "responsive pleading" (See: *Kelly vs. Delaware River Joint Commission*, 187 F. 2d 93, 94 [3rd Cir.]). On the Contrary, the Court is given a large measure of discretion under such circumstances, and leave to file an amended complaint should not properly be granted unless new facts are made to appear which would remedy the defects contained in the previous complaint (*Ginsberg vs. Stern*, 19 F. R. D. 238, 241 [W. D. Pa.]; and cf.: *Sidebotham vs. Robinson*, 216 F. 2d 816, 826 [9th Cir.]). The duty of the

Court on this motion, then, is to determine whether the proposed amended complaint states a cause of action, and thus, is entitled to filing.

Plaintiff has once again attempted to bring himself within the rule of *Gudger vs. Manton*, 21 Cal. 2d. 537. In that case it was held that the unjustified levy on a husband's separate property of an execution, issued as the result of a judgment obtained against his wife, constituted a disparagement of the husband's title, even though the underlying judgment was valid. Plaintiff here asserts that, even though the underlying contract between defendants and himself was valid, and therefore did not slander his title, the recordation of that contract created the false imputation or innuendo that the contract affected plaintiff's title to the timber. At the heart of plaintiff's theory in this connection is his contention that the recordation could not have been accomplished but for the false notarial certificate of acknowledgment.

As noted in this Court's previous opinion, no cause of action can be based on the falsity of the notarial certificate alone unless the underlying instrument itself is invalid for some reason (153 F. Supp. at 263). The distinction between the instant case and the case of *Greeninger vs. New Amsterdam Casualty Co.*, 152 A.C.A. 686, which plaintiff asserts controls the case at bar, is that in *Greeninger* the underlying instrument to which the notarial certificate was affixed was procured by fraud, whereas, in the instant case, no assertion has ever been made

that there is any doubt as to the validity of the underlying contract between plaintiff and defendants.

Hence, plaintiff's motion must stand or fall on whether the implication arising from the recollection of the contract that the contract affected plaintiff's title to the timber was an imputation or innuendo lacking in legal foundation so as to be actionable under the California law (See this Court's discussion of this requirement in 153 F. Supp. 263, at 264). The resolution of this issue depends upon the legal nature of the contract involved in this litigation, which is a question of law, and one which would have to be determined by the Court, either now or at some future point in the proceedings. Nothing will be gained by delay, so the issue may as well be resolved at this time.

Under the terms of this contract (a copy of which is appended to plaintiff's original complaint as Exhibit "A"), defendant Barnes was given the right to log, cut and market all of the "Prairie Creek" timber which was owned by plaintiff. Barnes was given, in short, complete control over the logging operations. Defendants, Huber & Goodwin, individually, and as a co-partnership, were required to handle the receipts and disbursements of funds arising from the transaction, and to give monthly accountings thereof. Plaintiff received a stipulated price per board foot of timber taken, and in addition, a certain specific percentage of the net proceeds of the operation. Each of the other parties

to the contract received a specific percentage of the net proceeds of the operation. The expiration date of the contract was set as May 4, 1958.

This contract was unquestionably one in which the right to cut, remove and market timber was transferred, which is in the nature of a contract for the sale of goods (*Ascherman vs. McKee*, 143 C. A. 2d 277, 282-3; *Palmer vs. Wahler*, 133 C. A. 2d 705, 711, 712). The right to remove timber under such a contract is characterized as a chattel real within the meaning of §765 of the California Civil Code, that is, an interest akin to a term for years (*Palmer vs. Wahler*, *supra*; and cf. *Dabney vs. Edwards*, 5 Cal. 2d 1, 6-11). A chattel real under §765 of the California Civil Code, even though characterized as a personal property right, by itself, nevertheless is considered an estate or interest in the particular property it affects within §761 of the California Civil Code (*German-American Savings Bank vs. Gollmer*, 155 Cal. 683, 686, 687). As such, it unquestionably affects the title to, or the possession of, real property within the meaning of §27280 of the California Government Code, and, thus, is entitled to recordation.

Furthermore, it has been specifically held that the recordation of a contract involving the right to remove timber within a specified period of time is not only proper, but will serve to constitute constructive notice to subsequent purchasers (*Mallett vs. Doherty*, 180 Cal. 225, 229). The Court is, therefore, of the view that since contracts such as that

which is here involved do affect the title to the land and the timber standing thereon, no false innuendo or imputation arose from the fact of recordation, even though the recordation itself may have been, or actually was, technically improper. Without such a false innuendo or imputation, the plaintiff's claim remains within the scope of the decision announced by this Court on June 24, 1957 (153 F. Supp. 260).

Under the rules, which have been set forth by this Court, in its previous Memorandum and in this Memorandum, the plaintiff failed to state a cause of action against the defendants in his initial complaint. Now, after careful study and reflection upon the subject, the Court is of the view that plaintiff simply cannot get himself over the legal barrier, which the facts asserted by plaintiff himself, have placed in front of him. This conclusion has been reached after examining and accepting as true, for the purposes of these proceedings, the allegations set forth in the Amended Complaint for Money, which plaintiff, by the instant motion, seeks to file in this action.

It Is, Therefore, Ordered that plaintiff's motion for leave to file his Amended Complaint for Money in this action be, and the same is, hereby denied.

Dated: December 18, 1957.

/s/ SHERRILL HALBERT,
United States District Judge.

[Endorsed]: Filed December 18, 1957.

[Title of District Court and Cause.]

Notice of Appeal to Court of Appeals

Notice Is Hereby Given that Bernard Kirsch, plaintiff above named, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the Order denying plaintiff's motion for leave to file an amended complaint herein entered in this action on December 18, 1957, and from the Order dismissing complaint entered in this action on June 24, 1957.

Dated this 30th day of December, 1957.

DAVID LIVINGSTON,
HAROLD R. FARROW,
JAMES R. MANSFIELD,

By /s/ DAVID LIVINGSTON.

[Endorsed]: Filed December 31, 1957.

[Title of District Court and Cause.]

STATEMENT OF POINTS ON WHICH
PLAINTIFF AND APPELLANT INTENDS
TO RELY ON THE APPEAL

Appellant has designated the complete record and proceedings to be contained in the record on appeal, and this statement of points which is required by rule 75 (d) only in the event that appellant does not designate for inclusion the complete record and all the proceedings and evidence in the

action is not intended as an indication that appellant does not desire the complete record and proceedings to be contained in the record on appeal. The points on which plaintiff and appellant intends to rely on appeal are as follows:

1. The District Court erred in granting defendants' motions to dismiss the complaint and in making its order dismissing the complaint dated June 24, 1957.

2. Said court erred in holding that plaintiff's complaint did not state a claim upon which relief could be granted.

3. Said court erred in denying plaintiff's motion for leave to file an amended complaint and in making its order denying said motion, dated December 18, 1957.

4. Said court erred in holding that plaintiff's amended complaint did not state a claim upon which relief could be granted.

Dated: January 2, 1958.

DAVID LIVINGSTON, et al.,

By /s/ DAVID LIVINGSTON,

Attorneys for Plaintiff.

Certificate of Service attached.

[Endorsed]: Filed January 3, 1958.

[Title of District Court and Cause.]

CERTIFICATE OF CLERK TO
RECORD ON APPEAL

I, C. W. Calbreath, Clerk of the District Court of the United States for the Northern District of California, do hereby certify that the foregoing and accompanying documents listed below, are the originals filed in this Court in the above-entitled case, and that they constitute the record on appeal herein as designated by the parties.

Complaint.

Motion to dismiss as to Deft. Barnes.

Motion to dismiss as to Defts Huber & Goodwin.

Memorandum & order.

Notice of motion for leave to file amended complaint.

Proposed amended complaint.

Memorandum & order.

Notice of appeal.

Cost bond on appeal.

Statement of points on which plaintiff intends to rely on appeal.

Appellant's designation of the record on appeal.

Order extending time to docket appeal.

In Witness Whereof, I have hereunto set my hand and the seal of said Court this 13th day of February, 1958.

[Seal] C. W. CALBREATH,
Clerk.

By /s/ C. C. EVENSEN,
Deputy Clerk.

[Endorsed]: No. 15891. United States Court of Appeals for the Ninth Circuit. Bernard Kirsch, Appellant, vs. George Barnes, Milton L. Huber, G. Edward Goodwin, Milton L. Huber & G. Edward Goodwin, a Copartnership Doing Business as Huber & Goodwin, Appellees. Transcript of Record. Appeal from the United States District Court for the Northern District of California, Northern Division.

Filed: February 14, 1958.

Docketed: February 19, 1958.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

No. 15,891

IN THE

United States Court of Appeals
For the Ninth Circuit

BERNARD KIRSCH,

Appellant,

VS.

GEORGE BARNES, MILTON L. HUBER, G.

EDWARD GOODWIN, MILTON L. HUBER and

G. EDWARD GOODWIN, a co-partnership,

doing business as Huber & Goodwin,

Appellees.

OPENING BRIEF FOR APPELLANT.

DAVID LIVINGSTON,

HAROLD R. FARROW,

JAMES R. MANSFIELD,

ROBERT R. BARTON,

2025 Russ Building,

San Francisco 4, California,

Attorneys for Appellant.

FILE

MAY 23 1958

PAUL P. O'BRIEN, CL

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No. 15,891

IN THE

United States Court of Appeals For the Ninth Circuit

BERNARD KIRSCH,

Appellant,

vs.

GEORGE BARNES, MILTON L. HUBER, G.

EDWARD GOODWIN, MILTON L. HUBER and

G. EDWARD GOODWIN, a co-partnership,

doing business as Huber & Goodwin,

Appellees.

OPENING BRIEF FOR APPELLANT.

1. **Statement of jurisdiction of the District Court and Court of Appeals and statutes involved.**

The complaint alleges diversity of citizenship and the requisite amount in controversy pursuant to U.S.C.A. Title 28, Sec. 1332 (T. 3-4).

A motion to dismiss the complaint was granted (T. 28). A motion by plaintiff for leave to file an amended complaint was denied (T. 46). Plaintiff appealed pursuant to Rule 73, Federal Rules of Civil Procedure. This court has jurisdiction of said appeal under U.S.C.A. Title 28, Section 1291.

The following statutes of California are involved:

Civil Code Sections 761, 1195; Government Code Sections 8214, 27280, 27286, 27287, 27288; Code of Civil Procedure Sections 338, 340, 343, 392, 738; Public Resources Code Section 5006; Penal Code Section 115.

2. Statement of the case.

This appeal involves the sufficiency of an amended complaint, leave to file which was denied after the District Court granted a motion to dismiss the original complaint.

Plaintiff was the owner of timber located in Humboldt County. By this action he seeks damages resulting from the recordation by defendants of a contract to which they had procured the attachment of a false notarial certificate. This certificate attested that the plaintiff had acknowledged his signature to the contract.

The contract was made on October 16, 1952 between plaintiff and defendants Barnes and Huber & Goodwin. It provided for the cutting of plaintiff's timber and the sale of his logs under the supervision of Barnes, and the collection of the proceeds by Huber & Goodwin. After payment of expenses and other fixed charges the balance was to be distributed by Huber & Goodwin in stated percentages. There was no transfer of title to the timber by plaintiff to Barnes or to Huber & Goodwin. No transfer of title occurred until the logs were sold to the ultimate consumer. Barnes was not authorized in his own right or for his own account to cut or remove the timber. Whatever services he performed were for the purpose of converting plaintiff's timber into cash so that it could be available for distribution. The contract did not affect

title to property and was not eligible for recordation (T. 11-14).

The contract was prepared by Huber & Goodwin who were and had for years been regularly employed as plaintiff's attorneys (T. 32). Defendant Barnes had for many years acted in a confidential capacity for plaintiff and procured sales of real property belonging to plaintiff which was located in the same vicinity as the timber above mentioned. In said transactions Huber & Goodwin had participated in their capacity as plaintiff's attorneys and in one instance had shared with Barnes in the commission paid by plaintiff for Barnes' services (T. 33).

Plaintiff never acknowledged execution of the contract. The false certification with respect to plaintiff's signature was hatched in the office of Huber & Goodwin. They had in their employ an attorney named Murray who also held a notarial commission. The defendants procured Murray to attach to the contract his certificate of acknowledgment by plaintiff (T. 34-5). This fact was concealed from the plaintiff.

The attachment of the false certificate was a part of a pre-conceived plan of defendants to qualify the contract for recordation and to create on the record an apparent encumbrance against plaintiff's title to the timber. Defendants' purpose was to place an obstacle in the way of any transaction into which plaintiff might thereafter enter with respect to the timber (T. 34).

In 1953, while the contract was in the course of performance, the State of California decided to acquire a portion of the timber for park purposes. The defendants were aware of the State's interest. While negotiations

were in progress, defendant Barnes surreptitiously and without plaintiff's knowledge and consent recorded the contract. This was done as a part of the plan devised as above stated and for the purpose of causing the title insurance company to refuse to pass the title to the timber and to note the contract as an exception to plaintiff's title and thereby prevent the sale. If the false certificate had not been attached the County Recorder would have refused to record the contract (Amended Comp. Par. IX, T. 37-8).

The recordation was concealed from the plaintiff and did not come to light until the sale to the state was about to be consummated (T. 38). As the defendants anticipated, the state required a policy insuring title to the timber, free and clear of encumbrances. The title search disclosed the contract on record. Consequently, the sale was delayed for a protracted period to the substantial damage of plaintiff (T. 37-8). The contract would have been disregarded if the false certificate had not been attached (T. 38-9). But the presence on record of a contract bearing what appeared to be an authentic certificate of acknowledgment and constituting a seeming encumbrance created a risk which the title company was unwilling to assume (Amended Comp. Par. X, T. 38).

As the result of defendants' chicanery the sale could not be completed until the apparent encumbrance was removed. In order to accomplish this plaintiff was compelled to escrow a large portion of the purchase price to provide for the satisfaction of any claims which defendants might establish against him under the contract (T. 38-9). These claims were involved in a lawsuit which in

the interim had been commenced in the District Court at Sacramento involving the legal effect of the contract. The amount retained in escrow above mentioned was to cover any judgment to be obtained by defendants in that lawsuit and was not limited to the amount of damages which defendants claimed with respect to the portion of the timber sold to the State.¹

As a result of the delay in the consummation of the sale to the State—proximately caused by the recordation of the contract with its false certificate of acknowledgment—plaintiff suffered damages in that (a) he was deprived of the income which would have been earned if the payment of the price had not been postponed and (b) he was compelled to pay taxes on the timber in the interim (T. 40-41). The activities of the defendants above set forth were not discovered by plaintiff until February 7, 1956 in the course of the trial of the lawsuit involving the controversy concerning the contract (T. 35-7).

3. Statement of question involved and the manner in which it is raised.

The question involved is whether the amended complaint states a claim against defendants upon which relief can be granted.

¹The aggregate amount placed in escrow was \$125,000. Judgment was given in favor of Barnes against Kirsch in the sum of \$45,492.20 and for Huber & Goodwin in the sum of \$21,865.90, making a total of \$67,358.10. Of this \$26,000 was awarded with respect to the timber acquired by the state. The defendants have refused to release the excess of the amount on deposit over the amount of the judgment with costs and anticipated interest.

This question is raised by the ruling of the District Court denying plaintiff's motion for leave to file an amended complaint.

The amended complaint states a cause of action based on two independent grounds:

(1) The conduct of the defendants constituted a false representation that the contract had been properly acknowledged by the plaintiff and was eligible for recordation. As the result, plaintiff's title to the timber was disparaged.

Plaintiff had the right to sell the timber to the state. In fact, confronted with the state's power of eminent domain, he had no alternative. If as the result of the sale the defendants would be deprived of a profit to which the contract entitled them, their remedy was to sue for damages. But they had no right by unlawful and criminal means to procure the recordation of the contract and thereby not only compel plaintiff to escrow funds for the account of defendants but also delay the consummation of the sale.

(2) The recordation of the contract with its counterfeit certificate of acknowledgment constituted a false representation that the contract affected the title to plaintiff's timber. The contract did not transfer any title to the timber nor did it constitute a sale thereof. It did not confer on any of the defendants the right to cut the timber in their own behalf or for their own account. It merely authorized Barnes in the capacity of general manager of the operation to supervise the logging of the property so that the logs could be sold and the proceeds divided in the manner stipulated in the contract.

4. Specification of errors relied on.

The District Court erred in holding that plaintiff's amended complaint did not state a claim upon which relief could be given and in denying plaintiff's motion for leave to file the amended complaint submitted on said motion. The District Court erred in holding that no facts could be stated by plaintiff upon which to support a claim entitling plaintiff to relief and in granting the motion to dismiss the complaint.

ARGUMENT.

5. The basis of the decision of the District Court.

The learned District Judge filed two opinions: The first granting defendants' motion to dismiss, and the second, denying plaintiff's motion to file an amended complaint. There is no substantial difference between the reasoning involved in the two opinions. The basic theory is (1) that the contract affected title to real property and was, therefore, eligible for recordation; (2) that the defendants were entitled to apprise the state of the existence of the contract even though they adopted criminal means to accomplish that result; and (3) that even though the sale to the state was indefinitely postponed to Kirsch's damage, he has no right to recover.

With all deference to the learned District Judge, we submit that all three of the foregoing propositions are erroneous. We submit that plaintiff was entitled to sell his timber without interference on the part of defendants, that if—notwithstanding the state's power of eminent domain—the sale gave rise to a claim in favor of Barnes,

Huber and Goodwin for the profit which they would have earned, their sole remedy was to sue Kirsch for such lost profit, and that they had no right to procure a false certificate of acknowledgment and to record the contract for the purpose of preventing the sale until Kirsch met their demands for escrow of funds to satisfy their claims. The defendants have inflicted a wrong upon the plaintiff; for every wrong there is a remedy; consequently, the defendants are liable to Kirsch for the damages which he has suffered as the result of defendants' activities.

6. By the use of criminal means the defendants obtained the false certificate of acknowledgment and thereby gave the contract the appearance of an instrument eligible for recordation. Their conduct in recording the contract constituted a false representation that the certificate was genuine. This plan was carried out for the purpose and with the effect of impeding the sale to the state. It inflicted injury on the plaintiff and defendants are liable in damages for his loss.

The contract with the signatures of its four parties was a perfectly honest agreement. It assured to Barnes, Huber & Goodwin a share of the net proceeds of Kirsch's logs when and if they were sold to the mill, provided that the sales price exceeded the stipulated items which must first be paid. It created no challenge to Kirsch's title or his ability to sell a portion of the lumber to the state. If such a sale was in contravention of the rights of Barnes, Huber & Goodwin, they were entitled to relief as in any case of contract. But they had no right for their own ulterior advantage to prevent the sale and thereby subject Kirsch to additional loss. Kirsch was in a veritable dilemma. The state's desire to acquire part of the timber for park pur-

poses rendered it impossible to remove it from the premises. If acquisition could not be accomplished by negotiation, the state's power of eminent domain could be invoked. The portion of the timber which the state wished to procure could not be cut. As to such timber the Barnes contract could not be performed. Assuming that the contract was irrevocable, Kirsch could not perform. Therefore, he was entitled to proceed with the sale to the state with reasonable dispatch and to make such accounting as the contract and applicable law required with respect to the other parties.

The certificate of acknowledgment was a complete fabrication. When it was attached the contract became a false instrument. It assumed the false guise of a document affecting Kirsch's title, in appearance eligible for recordation. When the contract was recorded it became a seeming encumbrance the effect of which was to deprive Kirsch of his right to dispose of his property. Kirsch's rights were invaded. This was not merely wrongful conduct. Under Section 115 of the Penal Code of California it was a criminal act.²

The invasion of Kirsch's rights was no accident. It was a calculated maneuver deliberately adopted for the express purpose of preventing Kirsch from consummating the sale to the state of a portion of the timber (T. 37-38).

²Penal Code, Section 115:

Procuring or offering false or forged instrument for record.

Offering false or forged instruments to be filed of record. Every person who knowingly procures or offers any false or forged instrument to be filed, registered, or recorded in any public office within this State, which instrument, if genuine, might be filed, or registered, or recorded under any law of this State or of the United States, is guilty of felony.

Suppose that Barnes had merely notified the state of the existence of the contract. This would not have disturbed the record title and the Title Insurance Company could have issued a policy containing no reference to the contract.

But even if by mere notice to the state Barnes could have stopped the sale, this did not entitle him to accomplish the same result by unlawful means and to be immune from liability.

The Title Insurance Company found the contract on record. Therefore, it had no alternative but to include it as an exception in any policy which it might issue.

Let us assume for the sake of argument that notwithstanding the decision of the state to acquire some of the timber,³ the defendants were nevertheless entitled to a percentage of the net proceeds which would have been produced by removal of the timber in accordance with the contract. Would this have justified the defendants in stopping the sale? Certainly not. The defendants had an appropriate remedy. But they were not satisfied with the protection provided by law. They undertook to take the law in their own hands and to prevent a sale unless it was

³The power of the State Park Commissioner to acquire property by purchase or condemnation is set forth in §5006 of the Public Resources Code of California which in part provides as follows:

The State Park Commission, with the consent of the Department of Finance, may acquire by purchase or by condemnation proceedings brought in the name of the people of the State of California, title to or any interest in real and personal property which the commission deems necessary or proper for the extension, improvement, or development of the State Park System. (Here follow provisions with respect to proceedings for condemnation.)

effected on their terms. Until their demands were satisfied by the escrow arrangements the sale was delayed. Hence, Kirsch not only was required to respond to all of defendants' claims under the contract and to provide security for payment of the claims; in addition he was subjected to long postponement of receipt of the sales price and consequent loss.

It makes no difference whether the case falls into one category or another nor what—to use the words of the learned District Judge—is “the gravamen of the action” (T. 27). Wrongful conduct caused damage and created a right to relief. The essence of Kirsch's loss was that his right to dispose of his property was obstructed. This was caused by the recordation of a false document, the falsity of which consisted in the representation that Kirsch's signature was properly attested so as to entitle the contract to recordation.

Cases involving similar injury are considered in the light of wrongful disparagement of title. For example, in *Davis v. Wood*, 61 Cal. App. 2d 788, 143 P. 2d 740, the Superior Court sustained a demurrer to the complaint without leave to amend. The appellate court reversed, holding that a cause of action had been stated. The court said:

From the foregoing statements of the law relating to damages for slander of title, or, to state it more accurately, for wrongful disparagement of title, it is apparent that the elements of damages are the loss caused by the impairment of vendibility and the cost of clearing the title. Therefore, in our opinion, a complaint which alleges that by reason of the recording of a notice of location by respondents the lease-

hold interest of appellant was greatly depreciated in value and was rendered unmarketable, to appellant's damage in the sum of \$10,000, states the ultimate fact of damages and is sufficient as against a general demurrer. (p. 798; p. 745)

In *Gudger v. Manton*, 21 Cal. 2d 537, 134 P. 2d 217, damages were recovered on the ground of disparagement of Gudger's title to real estate even though the defendants' conduct consisted merely of an imputation of a claim of interest in Gudger's property. The case involved the recordation of a writ of execution on a judgment against Gudger's wife. The judgment was not against Gudger because the liability arose out of a tort committed by Mrs. Gudger before she married Gudger. Manton's attorneys in California levied and recorded a writ of execution on the interest of Mrs. Gudger in a parcel of real estate which stood in Gudger's name. This was his separate property and Mrs. Gudger had no interest in it. On this factual basis Gudger sued Manton and his attorneys and was awarded \$16,000 in damages. This judgment was affirmed on the following ground:

The recording of the notice of the execution necessarily embraced the imputation that plaintiff's wife had the whole or a part interest in plaintiff's property, and that such interest was subject to the execution levy. Otherwise there would have been no reason for recording the writ and notice of execution. Such instruments on record had all the appearance of an assertion by defendants of a claim to an interest in the property, and as a matter of common knowledge would have an effect upon a prospective purchaser of the property and the merchantability of the title. He would naturally assume that plaintiff's title was

not merchantable, as it was encumbered by a lien to an indefinite extent. Defendants as reasonable persons should have reasonably foreseen that such would be the effect of their action. The essence of the matter is that there has been an actionable disparagement of title if the plaintiff has been proximately damaged thereby. . . . If the matter is reasonably understood to cast doubt upon the existence or extent of another's interest in land, it is disparaging to the latter's title where it is so understood by the recipient. (Rest. Torts, §629.) As we have seen, the reasonable imputation of the recording was a claim of an interest adverse to plaintiff's title. Whether a cloud on the title in the technical sense existed was immaterial. (pp. 542-3; p. 221)

The tortious conduct of defendants in the case at bar is much plainer. They made use of a false document intentionally falsified so as to make it effective for the intended purpose. The recordation was a clear-cut announcement that Kirsch had placed an encumbrance on his timber and had acknowledged his execution of the document so as to qualify it for recordation. This was not mere imputation or innuendo. It was not merely a circumstance from which it was possible to draw an inference of disparagement. On the contrary, it was deliberate and blatant.

In *Greeninger v. New Amsterdam Casualty Co.*, 152 Cal. App. 2d 645, 313 P. 2d 607, the court reversed a judgment after the sustaining of a demurrer without leave to amend—a situation exactly the same as at bar. The suit was on a notary's bond. It was based on the act of the notary in affixing to a deed a false certificate that

the grantor—Greeninger—had acknowledged its execution. The result was that the grantees who had procured Greeninger to sign the deed by fraud were enabled to record it and to sell the property to bona fide purchasers for value. There was no allegation that the notary was aware of the fraud. Nevertheless, the appellate court held that Greeninger could “have a cause of action based solely upon falsity of an acknowledgment” (p. 646; p. 609).

The court also referred to the provisions of the California codes concerning recordation and held:

It is common knowledge that, as a result of these provisions (Civ. Code §§ 1213, 1214), title insurance is normally issued only in favor of those grantees whose deeds are of record. Many purchasers will purchase land only if they can secure title insurance. It may be that appellant can, at trial, establish that the acknowledgment and recording of the deed to the Ruelles was an essential to their later sale to bona fide purchasers. (p. 647; p. 609)

The court also considered the contention of the notary and his surety that in order to recover on a false acknowledgment the complaining party must show that he relied upon it. The court conceded that this was the situation in prior cases but—the court explains—this was due to the fact that in those cases it was the grantee who was damaged and who was the plaintiff in the action. The court called this a “chance circumstance” and held that the right to recover was not limited to a grantee, as opposed to a grantor who is damaged by a false certificate. The court said:

Logically, the requirement should be only that the false certificate is a proximate cause of plaintiff's loss. (p. 646; p. 609)

Finally, on the question of proximate cause the court said that it could not be held as a matter of law that "the false acknowledgment could not be a proximate cause of the injury resulting to appellant from the sale to innocent third parties. As indicated, this is a question of fact, and not of law. Appellant is entitled to an opportunity to present the facts supporting her claim that proximate cause exists." (p. 647; p. 609)

7. The fact that the contract was valid does not deprive plaintiff of his right to recover.

The opinion of the learned District Judge denying the motion to amend states:

As noted in this Court's previous opinion, no cause of action can be based on the falsity of the notarial certificate alone unless the underlying instrument itself is invalid for some reason (153 F. Supp. at 263). (T. 43.)

We respectfully submit that the authorities cited above suffice to demonstrate otherwise. In *Gudger v. Manton*, 21 Cal. 2d 537, 134 P. 2d 217 (supra) the instrument which was placed on record was a writ of execution upon all the interest of Mrs. Gudger—the judgment debtor—in a parcel of real property. Mrs. Gudger had no interest in the property. It belonged to her husband. But the writ itself was not invalid. The vice of the activity on which the action was based was the use which was sought to be made of the writ. A valid instrument may be used in

such a way as to inflict injury. Likewise, in the case at bar the contract was used in an unlawful manner in order to accomplish an unlawful purpose and to cause Kirsch to suffer substantial loss.

The case here is the same as if Kirsch had borrowed money from Barnes and Goodwin and had given as security an order addressed to the sawmills authorizing the latter to pay the proceeds of the sale of any logs which Kirsch might deliver so that such proceeds could be applied on Kirsch's indebtedness. The order would be a valid instrument. But it would not give the defendants the right to procure the attachment of a false certificate of acknowledgment by Kirsch and the recordation of the order. It would not give the defendants the right to use the order in that manner so as to prevent Kirsch from selling his growing timber.

In support of his ruling that the invalidity of the underlying instrument is an essential factor of a cause of action, the first opinion of the District Judge (dismissing the complaint) cites *Heidt v. Minor*, 113 Cal. 385, 45 P. 700, and states:

Where a loss is sustained by reason of a false certificate of acknowledgment of a forged instrument the measure of damages recoverable for such official misconduct by the notary is determined by the evaluation of the rights which would have accrued to the injured party had the underlying instrument been valid (*Heidt v. Minor*, 113 Cal. 385; facts set forth at 89 Cal. 115). The clear implication from this rule is that there could be no recovery against the notary or his surety for his official misconduct in executing a false acknowledgment where the underlying instru-

ment is valid, for no measurable damages would result therefrom. (T. 25-26.)

Heidt v. Minor was a suit against the surety on a notary's bond. The decision is applicable only to the notary's liability. There is no warrant for an extension of the ruling to the case at bar where the wrongful acts were committed by parties whose deliberate purpose was to prevent the owner from making a sale of his property. The opinions of the learned District Judge contain no reason for any such extension.

Furthermore, the decision in *Heidt* is based on the particular circumstances of the case. It would not even be controlling in all actions involving the misconduct on the part of the notary. An analysis of the decision will readily demonstrate this.

Mrs. Heidt had made a loan and had received a mortgage as security. The mortgage was a forgery. Attached to it was a false certificate of acknowledgment by the purported mortgagor. The loan was not paid and Mrs. Heidt sued the notary's surety and recovered judgment for the amount of her loss.

The surety appealed on the judgment roll. He relied on the absence of any finding that if the mortgage had been genuine, it would have been of any value. The contention prevailed and the judgment was reversed. The appeal is reported at 89 Cal. 115, 26 P. 627. The ground of the reversal was that the misconduct for which the surety was liable was limited to attachment of the false certificate and if the property subject to mortgage was worthless, no damage would be suffered by the lender

which was attributable to the notary's misconduct. The court held:

And the plaintiff is not entitled to recover any more than her loss, by reason of said certificates being false instead of true. If the mortgages had been valid in every respect, their value as securities would have depended upon the value of the mortgaged property. (p. 121; p. 629.)

Then the court considers the result in the event that the value of the mortgaged property was less than the loan. The court said:

Otherwise they might be of less value, or no value at all, as in the case of *McAllister v. Clement*, 75 Cal. 182, in which the finding was, that the property mortgaged was wholly valueless, and that plaintiff had not suffered any damage by reason of the defective certificate of acknowledgment. The judgment in that case, in favor of the defendants, was affirmed by this court, on the ground that no action will lie to recover damages if no damages have been sustained. (p. 121; p. 629.)

Thus, it is clear that the determinative factor of the *Heidt* case is the matter of damages.

The case was tried a second time. Mrs. Heidt again prevailed. The surety appealed. Judgment was affirmed (113 Cal. 385, 45 P. 700). The court explained the prior decision (89 Cal. 115, 26 P. 627) as follows:

. . . and it was therefore held that upon those findings it could not have been ascertained whether or not plaintiff had suffered any loss *by reason of the false certificate*. (Italics quoted.) (p. 388; p. 701.)

The court held that this defect had been remedied by evidence at the second trial that the supposed mortgagor "was solvent, and able to pay the note set forth in the mortgage, and that had said mortgage been genuine, he would have paid that note", even though he "did not own, or claim to own, any part of the lands embraced in the mortgage." (pp. 388-9; p. 701.) The court held:

The value of the mortgage, therefore, depends not merely on the value of the mortgaged property, but, in case of the insufficiency of that property, upon the solvency of the mortgagor. When it appears, as it does in this case, that the plaintiff, had the mortgage been genuine, would have been able to collect the whole amount named therein, he is entitled to recover that amount without regard to the value of the mortgagor's interest in the mortgaged property. (p. 390; p. 701.)

The theory of the *Heidt* case is that the test as to damages depends on the question whether the property described in the mortgage is of any value and whether the purported mortgagor is financially responsible. If the property is valueless and the mortgagor is judgment-proof, it makes no difference whether the certificate of acknowledgment is true or false. Even if it was genuine, Mrs. Heidt would be in no better position. The determinative factor is not the invalidity of the underlying instrument. The District Judge's interpretation of the *Heidt* case is, we respectfully submit, erroneous.

The difference between *Heidt v. Minor* and the case at bar must be clear. Here the damage was inflicted by a disparagement of title accomplished by means of a false certificate of acknowledgment and recordation. These

damages do not depend on the invalidity of the contract. In *Heidt* there was no disparagement of title; there was no recordation.

Greeninger v. New Amsterdam Cas. Co., 152 Cal. App. 2d 645; 313 Pac. 2d 607 (supra) was decided July 19, 1957 in the interval between the two opinions of the learned District Judge in the case at bar. *Greeninger* was cited in support of plaintiff's motion to amend. In his opinion denying the motion the District Judge made the following comment:

The distinction between the instant case and the case of *Greeninger v. New Amsterdam Casualty Co.*, 152 A.C.A. 686, which plaintiff asserts controls the case at bar, is that in *Greeninger* the underlying instrument to which the notarial certificate was affixed was procured by fraud, whereas, in the instant case, no assertion has ever been made that there is any doubt as to the validity of the underlying contract between plaintiff and defendants. (T. 43-44.)

But the learned District Judge has overlooked the fact that the notary was not a party to the fraud by which *Greeninger* was induced to sign the deed. When the deed was presented to the notary on the day following signature it had all the appearance of a valid instrument. The sole misconduct on the part of the notary was his false certificate. Yet the court held that this could be a proximate cause of *Greeninger's* loss and that would suffice to impose liability on the notary and his surety.

The foregoing discussion should suffice to show that invalidity of the instrument is not an essential part of the cause of action for disparagement of title; also

that even in an action against the notary the requirement that the instrument be invalid is only applicable in the event that the same damage would be suffered by the complainant regardless of the truth of the certificate of acknowledgment.

8. The false certificate and not the contract was the cause of the disparagement of plaintiff's title.

In his first opinion the learned District Judge rejected the contention of plaintiff that "it was the untrue acknowledgment, and not the valid contract, which cast doubt on the plaintiff's title to the property, and thus caused the delay in the sale" (T. 27). The District Judge ruled that "Truth does not disparage" (id.). The answer is that when the false certificate was attached and used as a means of producing recordation the defendants were no longer in the realm of truth. They published a falsehood.

The District Judge also stated:

As such, the false certificate of acknowledgment, by itself, could impart no disparaging imputation or innuendo against plaintiff's interests in the timber. To conclude otherwise would be to indulge in a series of tenuous syllogisms unwarranted by the California law. (T. 27.)

The answer is that unless recorded with a certificate of plaintiff's acknowledgment attached, the contract would not have stopped the sale. This is not only self-evident. It is specifically alleged in the proposed amended complaint (T. 38-9). This allegation cannot be ignored. Hence, it was the false certificate that produced the disparagement of title.

The District Judge inferentially holds that the defendants had the right to publish the contract (T. 27-8). This is true provided that it was done for a legitimate purpose and not to impede the sale. Furthermore, the defendants would be restricted to the use of lawful—as opposed to dishonest—means. Even assuming that they could with impunity send the state agency a copy of the contract, they had no right to use recordation on the basis of a false certificate as the means of interference.

The District Judge holds that all that plaintiff “lost as a result of such recordation was his power to conceal the existence of the Barnes’ contract, which, so far as the record shows, was valid and binding as between the parties to it.” (T. 28.) The answer is the same as above set forth. The disclosure to the state of the existence of the contract would not have impeded the sale. The mere existence of the contract would not have provided a threat to the title which the state purposed to acquire. Hence, the plaintiff had no desire or reason to conceal the contract. But the recordation was something else. That gave the transaction the semblance of encumbrance. Confronted by this the state would not buy.

The answer to the theory of the decision of the District Judge is also found in *Greeninger v. New Amsterdam Cas. Co.*, 152 Cal. App. 2d 645, 313 P. 2d 607 (supra) where the court held:

To sustain the general demurrer here, it would be necessary to hold, as a matter of law, that the false acknowledgment could not be a proximate cause of the injury resulting to appellant from the sale to innocent third parties. As indicated, this is a question of fact, and not of law. Appellant is entitled to an

opportunity to present the facts supporting her claim that proximate cause exists. (p. 647; p. 609.)

9. Without Kirsch's acknowledgment the contract could not have been recorded and even if recorded, it would have been of no effect as to a subsequent purchaser.

In a footnote in the first opinion of the District Judge he refers to the certificates of acknowledgment by Barnes and Huber & Goodwin (T. 24), but he does not consider this as a ground for decision. Out of an abundance of caution we deem it advisable to discuss the point.

If the contract had been tendered for record without the acknowledgment of Kirsch, it would not have been accepted. This is alleged in paragraph IX of the proposed amended complaint (T. 38). Furthermore, Chapter 6 of the California Government Code controls the activity of County Recorders. Article 3 is entitled "Documents to be Recorded". Section 27288 requires that the instrument be "executed and acknowledged or proved as provided in Section 27287 by the party who appears by the instrument to be the party whose real property is affected or alienated thereby."⁴ Assuming that Kirsch's property was affected or alienated by the contract, his acknowledgment was essential.

Furthermore, even if by inadvertence the recorder were to overlook the absence of Kirsch's acknowledgment and to record the contract, this would be of no effect. In *Bell v. Sage*, 60 Cal. App. 149, 212 P. 404 (hearing in Supreme Court denied) one of two mortgagors failed to acknowledge her execution of the mortgage. The court held that recordation of the mortgage did not impart constructive

⁴Section 27288 is set forth in the appendix.

notice to subsequent purchasers.⁵ *Bell v. Sage* was approved and followed in *Keese v. Beardsley*, 190 Cal. 465, 213 P. 500.

In the argument in the District Court the contention was advanced by defendants that Kirsch's signature could have been proved by a subscribing witness (citing Section 1195 of the Civil Code).⁶ The District Judge did not discuss the point. The answer is first, that the signature was not so proved; instead a criminal means was employed; and second that no one signed a contract as a subscribing witness.

The defendants also cited Section 1207 of the Civil Code,⁷ providing that if an instrument affecting title to real property is copied into the proper book of record, then after the lapse of a year it imparts notice to subsequent purchasers even though unacknowledged. The answer is first, that there is no allegation that the year had elapsed when the sale was stopped; second, that the

⁵The opinion in *Bell v. Sage* is as follows:

Section 1161 of the Civil Code provides:

"Before an instrument can be recorded, . . . its execution must be acknowledged by the person executing it." Of course, the singular includes the plural, and where there are several grantors the acknowledgment of one of them is effective only as to his own grant and not as to those of the other grantors, in the absence of special statutory provision, and the record thereof is constructive notice only of the conveyance of the one who made the acknowledgment. (Webb on Record Titles, Sec. 58.) All of the decisions cited or discovered, with the exception of the early Massachusetts cases, support the rule as stated by the author. (Page 152; p. 406.) In other words, a defective execution or attestation as to one grantor, cannot be aided by a perfect execution and attestation as to other parties. To hold otherwise would be to defeat the manifest object of the registry laws, and to open a wide door to fraud. (Page 153; p. 406.)

⁶The Code section is quoted in the appendix.

⁷The Code section is quoted in the appendix.

recorder would not have accepted the contract for record in the absence of Kirsch's acknowledgment (Am. Comp. Par. IX, T. 38); and finally that Kirsch would have had an opportunity to have the recordation annulled if the circumstances of the false acknowledgment had been disclosed to him.

We conclude that the defendants' conduct in procuring the attachment of the false certificate constituted a false representation that the contract was eligible for record and that in procuring the recordation the defendants were guilty of wrongful disparagement of plaintiff's title.

We proceed to a discussion of the alternate and cumulative ground for relief which is set forth in the proposed amended complaint, viz. that the contract did not create any right in the defendants to the plaintiff's timber.

10. The contract did not affect title to or possession of real property and was not eligible for recordation. The applicable law of California.

At the root of the decision of the learned District Judge is the proposition that the contract "unquestionably affects the title to, or the possession of, real property within the meaning of §27280 of the California Government Code, and, thus, is entitled to recordation." (T. 45.) This requires an analysis and interpretation of the agreement. To assist in this process the applicable law of California as established by its appellate courts should first be ascertained.

Von Goerlitz v. Turner, 65 Cal. App. 2d 425, 150 P. 2d 278, involved a contract for the operation of a mine. It was agreed between the owners and the operators that

the latter should remove chrome ore from the mine "as long as ore can be found and price stays up" (p. 428; p. 279). The owners were to receive a percentage of the proceeds as royalty. The court held that it was apparent from the contract that "it did not create a right in the plaintiff's assignors to the exclusive use of the mine for a fixed term nor did it create an interest in the mine or the ore" (p. 429; p. 280). The court further held that the contract "merely provides for the operation of the mine on shares with provision as regards the compensation of the parties. . . . The agreement created no personal interest or right of exclusive possession, either in the mine or in the ore, in plaintiff or his assignors. Being merely a license to take ore from the mine, plaintiff's right thereto could arise only if and when it had been removed by him or his assignors." (pp. 429-30; p. 280.)

The foregoing decision is likewise applicable to the contract at bar which provides for the removal of timber, sale of the logs and division of the proceeds.

In *Crawford v. Pioneer Box Co.*, 105 Cal. App. 760, 288 P. 694, the original contract provided that Crawford should "fall, limb, buck and deliver to defendant's loading skids certain timber standing upon the lands described" (p. 762; p. 695). This was later modified to the effect that the defendant would pay Crawford, "over and above the price agreed upon in the original contract, the sum of \$1.00 per thousand for all logs delivered under the contract after July 31, 1926" (p. 763; p. 695). The court held:

Under the contract no interest in or title to the lands involved passed to plaintiff. All that distinguished plaintiff from a mere trespasser was the implied

license of defendant. The latter retained at all times control of the lands and the disposition of any timber thereon standing. (p. 767; p. 697.)

In *Hudepohl v. Liberty Hill Co.*, 80 Cal. 553, 22 Pac. 339, the decision is stated in the first paragraph of the syllabus as follows:

An agreement by a mining company, in the form of a lease for one year, giving to the lessee one half of the gross proceeds of the mine as a return for working the same in an energetic manner, and bearing all expenses, except necessary improvements, which are to be furnished by the lessor, does not create the relation of landlord and tenant, but is an agreement for working the mine on shares, and the parties become tenants in common of the products of the mine when taken out.

In *Rollins v. McDonald*, 7 Fed. 2d 422, the contract was in terms as well as legal effect substantially the same as the one at bar. Mrs. McDonald was the owner of standing timber "with the right to cut and remove the same before June 1, 1916" (p. 423). She made a contract with Fifield providing as follows:

1. The said Fifield agrees to cut, or cause to be cut all of the sawable lumber that can be cut and operated at a profit on said Rattlesnake Island on or before June 1, 1916, with such extension as can be secured; that the said Fifield shall either personally cut or cut by contract made by the said Fifield with some responsible party satisfactory to the said McDonald all of said trees on or before said date specified, all the bills of lading for the property thus cut being in the name of Fifield Lumber Company. The

said Fifield shall be in entire charge of the cutting and all other lumbering operations (p. 423).

Then followed a provision for payment to Mrs. McDonald of stumpage and one-half of the profits.

In affirming the judgment of the trial court the Circuit Court of Appeals interpreted the agreement as follows:

We also agree with his construction of the contract, that it was not a sale of the standing trees, but the employment of Fifield to cut and saw the same, and that the contract, read in the light of all the circumstances surrounding it and the usual conduct of lumbering operations, fairly disclosed that it was the intention of the parties that the title to the timber, when cut and sawed into lumber, should remain in the plaintiff with the right of possession until she should receive her stumpage of four dollars per thousand. (p. 425.)

There was a provision in the contract that Mrs. McDonald and Fifield "shall in no wise be considered partners" (p. 424). However, the Court of Appeals did not deem it necessary to mention this recital. In view of the terms of the agreement the recital was superfluous. Likewise, in the case at bar there is no basis for the conclusion that Kirsch entered into a partnership with the defendants.

In *Cloud v. Dean*, 102 So. 437 (Ala.), Cloud was the owner of timber. He made a contract virtually identical with that in the case at bar. Cloud agreed to permit Dean to cut and haul the timber to Mobile for sale. The contract provided that one-third of the proceeds from sale of the timber would be paid to Cloud and two-thirds to Dean, until Cloud had been paid \$300, and thereafter all of the

proceeds would be paid to the cutter Dean. In holding that the contract did not give Dean any title to the timber, the court said:

This was not a deed to the timber, but an agreement for the cutting and removal from the land to Mobile—an executory agreement to sell and convey the timber when severed and moved to the point indicated (p. 438).

It is generally held that to pass title to real property apposite words of conveyance indicating such intention of the parties are necessary. (citations) (p. 439).

11. **The agreement does not transfer title nor affect title to the timber. There is no change in the title until the logs are sold to the sawmill.**

The first recital is that Kirsch was the owner of the timber, “generally known as the Prairie Creek timber, and desires to log the same” (T. 11). This is followed by a recital that “Barnes is experienced in forestry and logging and is capable of causing said timber to be logged” (T. 11). Then the agreement states that “Huber & Goodwin are able to prepare all agreements required, collect and disburse the forthcoming proceeds, and so forth” (sic) (T. 12).

In the first covenant of the contract (paragraph (1)⁸) Kirsch merely grants “permission” to log his timber.

⁸“Kirsch agrees to permit the Prairie Creek timber aforesaid to be logged, commencing immediately and as rapidly as good forestry practices and market conditions permit. Barnes shall be and he is hereby designated the General Manager for the purpose of causing said timber to be logged economically, including the logging, relogging and making of split products thereon as economies permit.” Here follows Barnes’ agreement to enter immediately upon his duties, to take full charge of the operations, and

Barnes is designated as "general manager" of the operation. The clause demonstrates that Kirsch's status as owner is not modified or impaired. Barnes' position as general manager is typical of an employee—certainly not of an owner. His function involves one step in the process of converting the timber into cash.

Paragraph (2) of the agreement provides for delivery of logs to such consumer "as Barnes may from time to time select, at the maximum price which Barnes is able to obtain therefor". Barnes has no authority to collect the purchase price. On the contrary, this paragraph (2) provides that "payment for all logs shall be made directly from the purchasers thereof to Huber & Goodwin" (T. 12-13).

Obviously, this provision does not give Barnes or the firm of Huber & Goodwin any interest in the timber prior to its removal from the premises.

Paragraph (3) (T. 13-14) sets forth the manner in which the proceeds are to be disbursed by Huber & Goodwin.⁹

devote such time as is reasonably necessary. Barnes is also given discretion in the employment of loggers, truckers and other facilities (T. 12).

⁹The substance of the provision for disbursement of the proceeds is as follows:

(a) Huber & Goodwin are to pay expenses in accordance with invoices approved by Barnes.

(b) To pay Kirsch a fixed charge "for all logs sold". This is generally known in the industry as stumpage. The rate is \$8.50 per thousand board feet.

(c) To repay to Kirsch any advance made on and subsequent to October 15, 1952 (one day prior to the date which the contract bears) for "tractor work, road work, or any other expenses assumed and paid by Kirsch in preparing the property for logging",

The same paragraph provides for retention by Huber & Goodwin of a fund to pay "unanticipated expenses". It also provides for reports—at least monthly—accounting to Kirsch and Barnes for receipts and disbursements (T. 14).

These provisions contain express negation of the idea that any title to the timber or right to possession of the real property passed to Barnes or to Huber & Goodwin. Kirsch was entitled to stumpage on all timber to be cut. This was not to be paid by Barnes or by Huber & Goodwin. It was to come out of the price to be paid by the purchaser. The same arrangement is made with respect to logs which had been bucked prior to the contract and which were still located on the property.

Paragraph (4) undertakes to set up certain tax consequences. Normally, Kirsch's share of the proceeds of the timber would—to the extent that they exceeded his cost base—constitute capital gain, taxable at a fixed rate. On the other hand, the amount to be received by Barnes and Huber & Goodwin would constitute ordinary income and be taxable at higher graduated rates. Goodwin's plan, as set forth in paragraph (4), was to modify this consequence by fixing \$15.00 per thousand feet as the fair market value of the timber. The result would be that

thus demonstrating that it was contemplated that Kirsch would finance the operation with respect to the items mentioned.

(d) To pay Kirsch \$6.00 per thousand feet for all logs which he had theretofore felled, bucked and peeled and which were located on the premises and ready for transportation to the market.

(e) Finally, to divide the surplus on the basis of stated percentages.

the excess over expenses and stumpage up to \$15.00 would be deemed a capital gain and taxable at lower rates. This would be a decided advantage to Barnes, Huber and Goodwin. On the other hand, if the gross proceeds were more than \$15.00 per thousand, this excess would in the case of all four participants be taxable as ordinary income. This would be a disadvantage for Kirsch because all of his share of the net proceeds would otherwise have been taxable as capital gain to the extent that the amount so received exceeded his cost base.

We need not determine whether the Internal Revenue Service would tolerate this legerdemain. The fact is clear that there is nothing in this provision which indicates any transfer by Kirsch to the other parties of title to the timber. On the contrary, the effect of the clause is to recognize that Kirsch's title is to persist until sale to the consumer. An artificial arrangement is set up to give Barnes, Huber and Goodwin a favorable tax position.

The foregoing analysis demonstrates that there is no basis for the District Court's conclusion that the contract constituted a transfer of title or that it affected title to the timber so as to make it eligible for recordation. No transfer of title would occur until sale and delivery of the logs to the consumer. Thereupon Barnes and the firm of Huber & Goodwin would become entitled to a share of the net proceeds after making the deductions in accordance with the terms of the agreement.

It is interesting to note that in the course of the argument of Kirsch's motion to amend, counsel appearing for Barnes expressly conceded that the contract did not affect title. In their brief in opposition to the motion they state:

All that happened was that Barnes took a document down to the County Recorder's office which did not affect title . . .

The fact that the contract did not affect title to the real property or possession of real property did not render it non-recordable.

(p. 3-4)

Of course, the concession of opposing counsel is not controlling. But it is certainly worthy of consideration.

12. Analysis of the reasoning and cases cited in the opinion of the District Judge in support of the decision that the contract affected "the title to the land and the timber standing thereon" (T. 45-6).

The opinion denying plaintiff's motion to file an amended complaint states that "defendant Barnes was given the right to log, cut and market all of the Prairie Creek timber which was owned by plaintiff. Barnes was given, in short, complete control over the logging operations" (T. 44).

There is no doubt that Barnes was given control over the logging operations. But this did not divest Kirsch of any title to his timber or to the logs. As to the court's statement that "Barnes was given the *right* to log, cut and market" the timber, there is no such provision in the agreement. The supervision of the logging was not a right; it was a function which Barnes was to pursue—a job. The authority conferred on Barnes does not constitute a transfer of title.

The opinion then states that "the right to cut, remove and market timber was transferred, which is in the nature of a contract for the sale of goods" (T. 45). The answer

is first, that there was no transfer of title; and second, that the permission to remove Kirsch's timber does not constitute a transfer of anything but merely creates a license. The contract merely made it possible for Barnes, Huber and Goodwin to participate in the proceeds of sale in return for the services which they were to perform.

It is elementary that in a contract for the sale of goods there must be a seller and a buyer. Kirsch did not sell his standing timber to Barnes or to Huber & Goodwin. They did not buy the logs. The only sale contemplated was to the sawmill. That sale was not accomplished by the agreement. It would not occur until the logs were removed and delivered to the mill. Then for the first time there was "a sale of goods". We respectfully submit that the learned District Judge was in error in holding that the agreement at bar was for the sale of goods by Kirsch to the defendants.

In support of his ruling the opinion cites *Ascherman v. McKee*, 143 Cal. App. 2d 277, 299 P.2d 367¹⁰ (T. 45). The transaction involved in *Ascherman* was quite different from that at bar. In the *Ascherman* case the District Court of Appeal describes the contract as one "for the purchase and sale of the right to cut and remove, on or

¹⁰It should be noted that all citations in the opinion on this subject are without any discussion of the point actually decided.

It is also noteworthy that none of the cases mentioned by the District Judge on this subject were cited by defendants in their briefs. The defendants were content to let the District Judge assume the burden of research. As stated above, counsel for Barnes conceded that the contract did not affect title. The result was that these cases appeared for the first time in the opinion denying leave to file the amended complaint. Consequently, plaintiff's counsel had no opportunity to discuss them or to seek to convince the District Judge that they are not in point.

before July 31, 1956, all fir and pine timber 20 inches and larger in diameter standing on certain described real property owned by plaintiff'' (p. 279; p. 368). The contract price was \$20,000, of which \$5,000 was immediately payable and the balance in subsequent installments. Thus it is clear that Mrs. Ascherman was the seller and the McKees were the buyers. It was a clear-cut transfer of title to the timber. We submit that there is no similarity between the Ascherman contract and the one at bar.

Then the opinion of the District Judge states:

The right to remove timber under such a contract is characterized as a chattel real within the meaning of §765 of the California Civil Code, that is, an interest akin to a term for years (T. 45).

In support of this statement the opinion cites *Palmer v. Wahler*, 133 Cal. App. 2d 705, 285 P.2d 8. The implication is that the *Palmer* case decides that a party in the position of Barnes is under the contract at bar the holder of an estate for years. The fact is that in *Palmer v. Wahler* it was the Wahlers—the parties in the same position of Kirsch—who were held to be the owners of a chattel real. This can be readily demonstrated by an analysis of *Palmer v. Wahler*. It will be also clear that the instrument under which the Wahlers held title to the timber was altogether different from the contract at bar.

First it should be noted that Palmer, an unlicensed broker was suing for a commission which had been orally promised him for finding a buyer of the timber. The Wahlers defended on the ground that Palmer had no license and the oral agreement was invalid under the statute of frauds. The court held that "a so-called 'finder's

agreement' falls neither within the purview of the statute of frauds nor the real estate licensing acts'' (p. 710; p. 12). As an additional reason for the affirmance of the judgment the court held that the transaction between the Wahlers and the buyer procured by Palmer constituted a sale of goods or personal property, and therefore, the employment of the broker did not come within the statute of frauds (p. 711; p. 12). It was in this connection that the District Court of Appeal held:

Here neither the appellants (the Wahlers) nor their co-owners in the timber had any interest in the land upon which it stood. The time within which they could enter and remove the timber was limited by the terms of the grant to December 31, 1954. Therefore the "estate" which was the subject matter of the contract of sale was but one for years and was subject to disfeance at the expiration of a fixed term (p. 711; pp. 12-13).

The Wahlers' status was the same as that of Kirsch. He owned the timber subject to the obligation to remove it within the stipulated time. The State owned the land. Kirsch's estate was "one for years". On the other hand, there is no similarity between the status of Barnes and Huber & Goodwin and that of the Wahlers. The contract did not constitute the defendants as owners of an estate for years. *Palmer v. Wahler* does not support the decision of the District Judge in the case at bar.

In the same connection the opinion of the District Judge cites *Dabney v. Edwards*, 5 Cal. 2d 1, 6-11, 53 P.2d 962, This was a suit by a broker for commissions for selling oil leases belonging to Edwards. Again the question was whether the transaction came within the statute

of frauds. The Supreme Court held that an oil lease for a fixed term is an estate for years. Obviously the defendants at bar were not lessees and the *Dabney* case is not pertinent here.

Having adopted the erroneous premise that Barnes alone—or together with Huber & Goodwin—was the owner of a chattel real, the opinion of the learned District Judge concludes that a chattel real is “considered an estate or interest in the particular property it affects within §761 of the California Civil Code” and is therefore “real property within the meaning of section 27280 of the California Government Code, and, thus, is entitled to recordation” (T. 45). The error of the premise demonstrates the fallacy of the conclusion.

In this connection the opinion (T. 45) cites *German American Savings Bank v. Gollmer*, 155 Cal. 683, 102 P. 932. This case involved a lease of real property which was held to be an estate for years within the definition of Civil Code section 761. On this ground the court decided that the lessee could avail himself of section 738 of the Code of Civil Procedure which provides for an action “by any person against another who claims an estate or interest in real property adverse to him for the purpose of determining such adverse claim”.

Obviously, the contract at bar has none of the characteristics of a lease. Barnes was not a lessee. He could not successfully maintain an action to quiet title. Therefore the *Gollmer* case is not in point.

The final citation in the opinion on this point is *Mallett v. Doherty*, 180 Cal. 225, 180 P. 531, in which—according

to the learned District Judge—the California Supreme Court “specifically held that the recordation of a contract involving the right to remove timber within a specified period of time is not only proper but will serve to constitute constructive notice to subsequent purchasers” (T. 45). The answer is that *Mallett v. Doherty* did not involve merely a “right to remove timber”. On the contrary, there was a conveyance of the timber for a fixed price. The document read as follows:

That for and in consideration of the sum of Three Thousand Dollars, the said party of the first part does hereby grant, bargain, sell and convey to the party of the second part, all timber suitable for saw-mill purposes, and standing and being upon the following described Real Estate, . . . together with the free use and occupation of said premises and appurtenances, without charge, for the purpose of cutting, hauling, and sawing said timber (p. 227; p. 531).

Thus, it is clear that Mallett became the sole and exclusive owner of the timber together with the right of occupation of the premises. Consequently, he was entitled to record the document so as to give constructive notice to the world and protect his title against any subsequent purchaser for value. The defendants occupied no such status and had no such right.

13. The fact that the contract—even though recorded—imposed no encumbrance on the timber does not deprive plaintiff of his right to recover.

It has been contended by the defendants that if the contract did not affect title, then its recordation did not impose an encumbrance on Kirsch’s timber or prevent the sale. The same theory was advanced in *Gudger v. Manton*,

21 Cal. 2d 537, 134 P.2d 217 (supra). The defendant there argued that “the levy of and recording of a writ of execution upon the real property of another, not a party to the judgment, does not constitute a lien nor cloud upon the title, and where the judgment debtor has no interest in the property, no right of the owner thereof is affected, and therefore it cannot be the basis for a disparagement of title action” (p. 541; p. 220). The answer—equally appropriate in the case at bar—was given by the Supreme Court as follows:

Whether a cloud on the title in the technical sense existed was immaterial. While it is true the execution claimed only such interest as plaintiff’s wife had in the property, the only reasonable implication is that in fact the wife did have an interest in the property and a lien thereon was claimed (p. 543; p. 221).

14. The action is not barred by the statute of limitations.

The first opinion dismissing the complaint contains the following footnote:

The statute of limitations as a defense is not pressed by the defendants, and in view of the conclusions reached herein, the Court has not deemed it necessary to reach this issue at this time (T. 21).

Nevertheless, we deem it advisable to demonstrate that the action is not barred.

The applicable statute is Section 338 of the California Code of Civil Procedure.¹¹

Section 338 fixes three years as the period for an action for injury to real property. In *Coley v. Hecker*, 206 Cal.

¹¹The pertinent portions of Section 338 of the Code of Civil Procedure are set forth in the appendix.

22, 272 Pac. 1045, an action for slander of title was held to be one for injury to real property for the purpose of determining proper venue. Section 392 in the Code of Civil Procedure¹¹ provides for the trial for such an action in the county in which the subject of the action is situated. The decision of the Supreme Court is stated in the syllabus as follows:

(4) Place of Trial—Slander of Title—Injury to Real Property—Section 392, Code of Civil Procedure.—In such a case, slander of title is an injury to real property, and the contention that the term “injury to real property”, as used in section 392 of the Code of Civil Procedure, was intended to include only physical interference with or physical injury to real property, cannot be sustained.

The foregoing reasoning is likewise applicable to the statute of limitations.

Coley v. Hecker was followed in *Smith v. Stuthman*, 79 Cal. App. 2d 708, 181 Pac. 2d 123, holding that an action for slander of title is one “for redress of an invasion of a particular property right” (p. 709; p. 124). Accordingly, the court held that the action—unlike one for a personal tort—survived the death of the wrongdoer. Another decision indicating that this is not an action for “libel or slander . . . of a person” within the one year statute (CCP Section 340¹²) is *Albertson v. Raboff*, 46 Cal. 2d 375, 295 Pac. 2d 405, holding:

. . . the gravamen of an action for disparagement of title is different from that of an action for personal defamation . . . (p. 378; p. 408).

¹²The pertinent portion of this section is set forth in the appendix.

The damages suffered by Kirsch were not fully accrued until June 29, 1956 (Am. Comp. Par. X, T. 38). The sale to the State was delayed from July 27, 1954 to June 29, 1956 (id. Par. XII, T. 40). Whichever of these two dates is determinative the three year period had not expired on November 30, 1956 when the complaint was filed (T. 17).

Slander of title, based on the recordation of a false document, is a continuing tort. In *Coley v. Hecker*, 206 Cal. 22, 272 Pac. 1045, the Supreme Court held:

. . . in the instant case the libel was recorded in the office of the county recorder where the land was situate and constituted a continuing, permanent notice to the world that a judgment lien to the extent of \$12,000 rested upon respondent's real property (p. 29; p. 1048).

In *Kafka v. Bosio*, 191 Cal. 746, 218 Pac. 753, the Supreme Court quoted from Cyc. as follows:

“Where continuing or recurring injury results from a wrongful act or from a condition wrongfully created and maintained, such as a continuing nuisance or trespass, there is not only a cause of action for the original wrong arising when the wrong is committed, but separate and successive causes of actions, for the consequential damages arise as and when such damages are from time to time sustained; and therefore so long as the cause of the injury exists and the damages continue to occur, plaintiff is not barred of a recovery for such damages as have accrued within the statutory period beyond the action, although a cause of action based solely on the original wrong may be barred” (p. 751; pp. 755-756).

Now we will assume for the sake of argument that plaintiff's cause of action is deemed to have accrued on

the date when the contract was recorded. Even on this assumption the statute of limitations would be tolled by reason of defendants' concealment and the confidential relations between the parties. Therefore, Kirsch was entitled to sue within a reasonable time after he discovered the fraudulent certificate of acknowledgment. This was in February, 1956 while another suit between the same parties was on trial (Am. Comp. Par. VIII, T. 35-37). Hence, the suit was in time.

The conduct of defendants in procuring the false certificate of acknowledgement and recording the contract was not only surreptitious; it constituted a fraudulent concealment. Under settled California law, this tolls the statute of limitations until discovery by the plaintiff. The principle was originally adopted in *Kane v. Cook*, 8 Cal. 449. It has been consistently followed. For example, in *Kimball v. Pacific Gas & Electric Co.*, 220 Cal. 203, 30 Pac. 2d 39, the court held:

We are of the opinion, however, that independent of statute, the fraudulent concealment by the defendant of the facts upon which a legal common-law action was based, under the proper circumstances, tolls the statute until discovery and that upon discovery the statute applicable to that particular action (in this case Code Civ. Proc., sec. 340, subd. 3) then commences to run (p. 210; p. 42).

The confidential status of Huber & Goodwin as Kirsch's attorneys and Barnes as Kirsch's broker is set forth in the Amended Complaint (Par. IV, T. 32; Par. V, T. 33; Par. VI, T. 33; Par. VIII, T. 35). The concealment is alleged in Par. VII, T. 34-35.

When Kirsch learned that the contract had been recorded, he was not obligated to make an investigation in the recorder's office, nor to know that the recorder would require a certificate of acknowledgment of Kirsch's signature, nor to conclude that such a certificate had been attached to the contract. Kirsch had signed other papers prepared by Huber & Goodwin (Am. Comp.; Par. VIII, T. 35). He was not obliged to note nor to charge his memory with the particular circumstances with respect to the signature of the contract in suit so as to suspect foul play when the delay of the sale came to his attention. He was not obliged to make an investigation of the conduct of his attorneys and broker—the co-parties to the contract—for the purpose of discovery of the falsity of the certificate. He had the right to assume that they had acted lawfully and properly.

In *Bennett v. Hibernia Bank*, 47 Cal. 2d 540, 305 Pac. 2d 20, the Supreme Court explains the effect of a confidential relationship with respect to the duty of inquiry. The court held:

In view of the allegations indicating that a fiduciary relationship existed, the fact that a document disclosing these events was a matter of public record filed with the Secretary of State cannot alone cause the statute to run (p. 562; p. 34).

The documents filed in that year, while public records and constructive notice for certain purposes, are not sufficient to start the running of the statute in favor of the fiduciary as to those of its members who had no knowledge of them (p. 562; p. 34).

Plaintiffs must allege and prove facts showing the time and surrounding circumstances of the discovery of the cause of action upon which they rely. (*Hobart v. Hobart Estate Co.*, 26 Cal. 2d 412, 441-443 (159 P. 2d 958).) The purpose of this requirement is to afford the court a means of determining whether or not the discovery of the asserted invasion was made within the time alleged, that is, whether plaintiffs actually learned something they did not know before. In applying this rule it is important to recognize the distinction between cases where a plaintiff is under a duty to inquire and those in which he has no such duty until he has notice of facts sufficient to arouse the suspicions of a reasonable man. Where there is no such duty, for example, because of the existence of a fiduciary relationship, a plaintiff need not disprove that an earlier discovery could have been made upon a diligent inquiry but need show only that he made an actual discovery of hitherto unknown information within the statutory period before filing the action. (*Hobart v. Hobart Estate Co.*, 26 Cal. 2d 412, 442 (159 P. 2d 958).) The circumstances of the discovery which, according to the complaint, was made within two years prior to the filing of the action are sufficiently alleged to meet the requirements of the rule set forth above (pp. 563-4; p. 35).

In *Schaefer v. Berinstein*, 140 Cal. App. 2d 278, 295 Pac. 2d 113, the court held:

In cases involving confidential relationships, the rule requiring allegations stating the circumstances which are relied upon by the plaintiff as excusing prior discovery of the fraud is relaxed. (*Bainbridge v. Stoner*, 16 Cal. 2d 423, 430 (106 P. 2d 423).) In *Hobart v. Hobart Estate Co.*, 26 Cal. 2d 412 (159 P. 2d 958),

the court points out that it is recognized that in cases involving a fiduciary relationship "facts which would ordinarily require investigation may not excite suspicion, and that the same degree of diligence is not required" (p. 296; p. 125).

The effect of the confidential relationship upon transactions between an attorney and client is axiomatic. The subject is discussed at length in *Estate of Witt*, 198 Cal. 407, 245 Pac. 197 and *Cox v. Delmas*, 99 Cal. 104, 33 Pac. 836.

Even if the recordation of the contract had brought to Kirsch's mind the subject of acknowledgment and he had made an effort to reach a solution, there was every good reason why he should have concluded that a notary was available at the time that the contract was signed and that the certificate was in order.

In *California Sav. Etc. Soc. v. Culver*, 127 Cal. 107, 59 Pac. 292, the Supreme Court held that if the facts present a doubtful case as to the statute of limitations, the court will not indulge in a strained construction in order to support the defense.

In *Rutherford v. Rideout Bank*, 11 Cal. 2d 479, 80 Pac. 2d 978, the opinion states:

The courts will not lightly seize upon some small circumstance to deny relief to a party plainly shown to have been defrauded against those who have defrauded him on the ground, forsooth, that he did not discover the fact that he had been cheated as soon as he might have done. It is only where the party defrauded should plainly have discovered the fraud except for his own inexcusable inattention that he will

be charged with discovery in advance of actual knowledge on his part (pp. 485-6; p. 982).

We conclude that the action is not barred by the statute of limitations.

Dated, San Francisco, California,
May 12, 1958.

Respectfully submitted,

DAVID LIVINGSTON,

HAROLD R. FARROW,

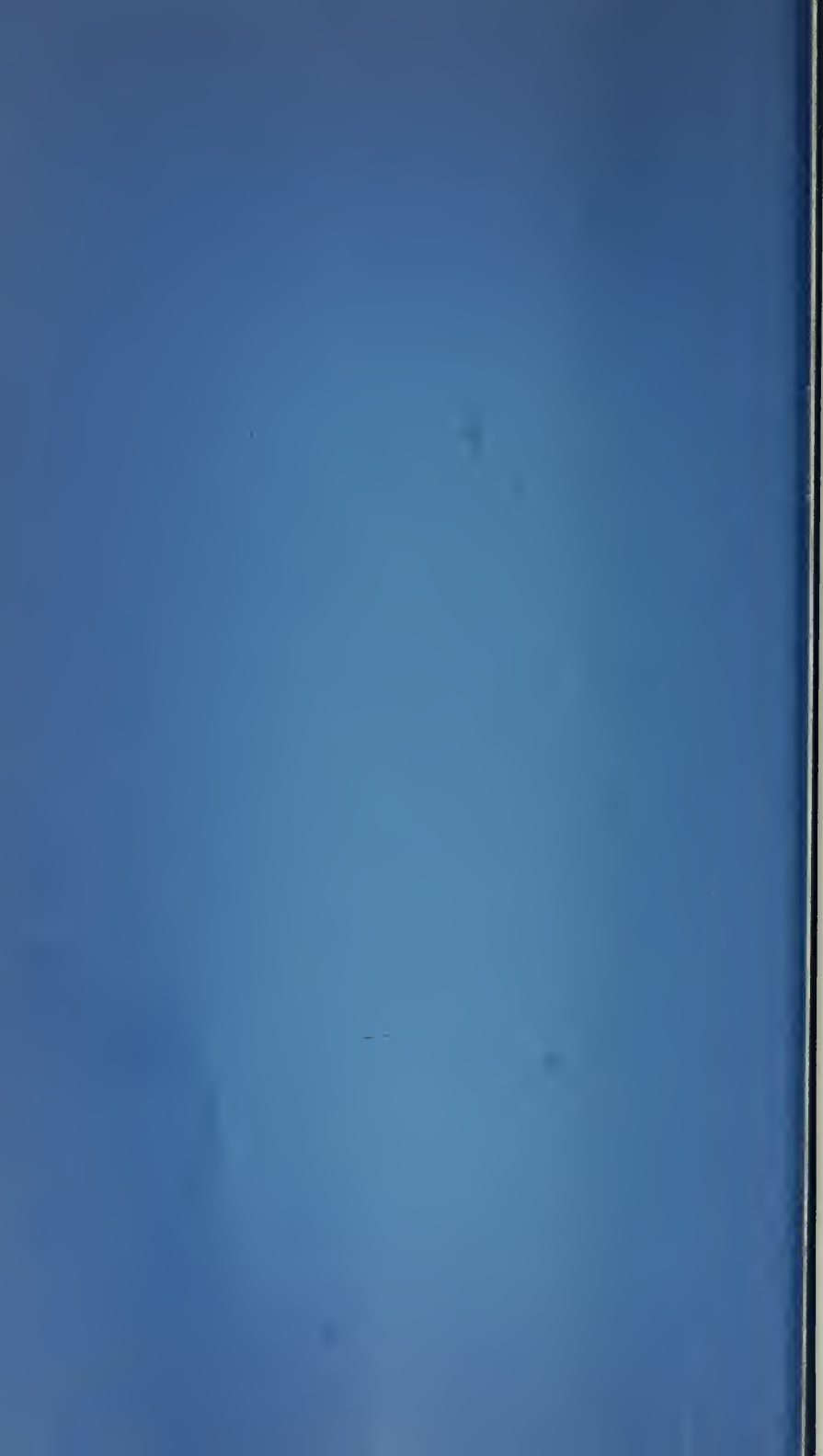
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Attorneys for Appellant.

(Appendix Follows.)

Appendix.



Appendix

Civil Code Section 761:

Enumeration of estates. Estates in real property, in respect to the duration of their enjoyment, are either:

1. Estates of inheritance or perpetual estates;
2. Estates for life;
3. Estates for years; or,
4. Estates at will.

Civil Code Section 1195:

§ 1195. Proof of execution, how made. Proof of the execution of an instrument, when not acknowledged, may be made either:

1. By the party executing it, or either of them; or,
2. By a subscribing witness; or,
3. By other witnesses, in cases mentioned in section eleven hundred and ninety-eight.

Civil Code Section 1207:

§ 1207. (Notice by defectively executed or acknowledged instrument: Certified copies as evidence.) Any instrument affecting the title to real property, one year after the same has been copied into the proper book of record, kept in the office of any county recorder, imparts notice of its contents to subsequent purchasers and encumbrancers, notwithstanding any defect, omission, or informality in the execution of the instrument, or in the certificate of acknowledgment thereof, or the absence of any such certificate; but nothing herein affects the rights of purchasers or encumbrancers previous to the taking effect of this act. Duly certified copies of the record of any such instru-

ment may be read in evidence with like effect as copies of an instrument duly acknowledged and recorded; provided, when such copying in the proper book of record occurred within five years prior to the trial of the action, it is first shown that the original instrument was genuine. (Added by Code Amdts. 1873-74, p. 228; Am. Stats. 1897, p. 64; Stats. 1901, p. 398 (Unconstitutional); Stats. 1903, p. 108; Stats. 1909, p. 45; Stats. 1913, p. 75; Stats. 1915, p. 1211; Stats. 1919, p. 244; Stats. 1921, p. 94; Stats. 1927, p. 828.)

Code of Civil Procedure Section 338:

§ 338. Within three years:

. . .

2. An action for trespass upon or injury to real property.

Code of Civil Procedure Section 340:

Within one year:

.

3. An action for libel, slander, assault, battery, false imprisonment, seduction of a person below the age of legal consent, or for injury to or for the death of one caused by the wrongful act or neglect of another, . . .

Code of Civil Procedure Section 343:

§ 343. . . . An action for relief not hereinbefore provided for must be commenced within four years after the cause of action shall have accrued.

Code of Civil Procedure Section 392:

§ 392. . . . (1) Subject to the power of the court to transfer actions and proceedings as provided in

this title, the county in which the real property, which is the subject of the action, or some part thereof, is situated, is the proper county for the trial of the following actions:

(a) For the recovery of real property, or of an estate or interest therein, or for the determination in any form, of such right or interest, and for injuries to real property; . . .

Code of Civil Procedure Section 738:

Action to quiet title to real and personal property. An action may be brought by any person against another who claims an estate or interest in real or personal property, adverse to him, for the purpose of determining such adverse claim . . .

Government Code Section 27280:

Instruments or judgments affecting title. Any instrument or judgment affecting the title to or possession of real property may be recorded pursuant to this chapter.

Government Code Section 27287:

Acknowledgment of execution: Proof by subscribing witness, etc.: Certification. Unless it belongs to the class provided for in either Sections 27282 to 27286, inclusive, or Sections 1202 or 1203, of the Civil Code, or is a fictitious mortgage or deed of trust as provided in Section 2952 of the Civil Code, before an instrument can be recorded its execution shall be acknowledged by the person executing it, or if executed by a corporation, by its president or secretary or other person executing it on behalf of the corporation,

or proved by a subscribing witness or as provided in Sections 1198 and 1199 of the Civil Code, and the acknowledgment or proof certified as prescribed by law.

Government Code Section 27288:

Section 27288: If the instrument is an agreement for sale, lease, option agreement, deposit receipt, commission receipt, or affidavit which quotes or refers to an agreement for sale, lease, option agreement, deposit receipt, commission receipt, or lease and such instrument claims to, or affects any interest in real property, it shall be executed and acknowledged or proved as provided in Section 27287 by the party who appears by the instrument to be the party whose real property is affected or alienated thereby.

No. 15,891

IN THE
United States Court of Appeals
For the Ninth Circuit

BERNARD KIRSCH,

Appellant,

vs.

GEORGE BARNES, MILTON L. HUBER, G.

EDWARD GOODWIN, MILTON L. HUBER

and G. EDWARD GOODWIN, a co-partnership, doing business as Huber & Goodwin,

Appellees.

REPLY BRIEF OF PLAINTIFF AND APPELLANT
BERNARD KIRSCH.

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SEP 30 1958

PAUL P. O'BRIEN, CL.

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No. 15,891

IN THE
United States Court of Appeals
For the Ninth Circuit

BERNARD KIRSCH,

Appellant,

vs.

GEORGE BARNES, MILTON L. HUBER, G.

EDWARD GOODWIN, MILTON L. HUBER

and G. EDWARD GOODWIN, a co-part-

nership, doing business as Huber &

Goodwin,

Appellees.

REPLY BRIEF OF PLAINTIFF AND APPELLANT
BERNARD KIRSCH.

The Merits of the Cause of Action for Disparagement.

1. There was no necessity for alleging that the contract did not confer rights on the defendants or that such rights did not relate to plaintiff's property. Any such allegations would have been conclusions of law and improper.

At the outset of the brief filed by Messrs. Hill and Hill in behalf of appellee, George Barnes (herein called the Hill brief) under the heading "Preliminary Statement" it is said (p. 4):

There was no allegation in either complaint that the contract did not give defendants genuine contract

rights, nor is there any allegation to the effect that such rights did not relate to and thus affect appellant's property, i.e., his timber.

Such allegations would have been improper as constituting legal conclusions. The contention that the amended complaint is wanting in this respect is without merit.

2. The false certificate was the means of procuring recordation of the contract and consequent disparagement of plaintiff's title.

The Hill brief (p. 15) quotes from Judge Halbert's first opinion a comment concerning the function of a certificate of acknowledgment and the statement therein that "the false certificate of acknowledgment, by itself, could impart no disparaging imputation or innuendo against plaintiff's interest in the timber" (T. 27). Our opening brief demonstrates that the cause of action is based not merely on the false certificate but on the ground that this certificate was attached to the contract. By this means the contract became seemingly eligible for recordation as a conveyance by Kirsch. As the result of recordation the contract became a cloud on Kirsch's title.

This explanation of the case is ignored in the Hill brief. The brief does consider the decision in *Greeninger v. New Amsterdam Cas. Co.*, 152 Cal. App. 2d 645, 313 Pac. 2d 607, and states that there "the specific issue was whether the notary's alleged misconduct was the proximate cause of damage" (br. p. 16). This is not correct. The principal aspect of *Greeninger* is that a false certificate when used to the damage of a person can be the basis of a cause of action (see op. br. p. 14). The question of

proximate cause arose only after the primary issue was determined.

The *Greeninger* case is a complete answer to the theory of the learned District Judge as to the function of a certificate of acknowledgment. It also disposes of the contention that a cause of action cannot be based on the injurious use of the false certificate alone.

The Hill brief (p. 16) repeats Judge Halbert's discussion of the *Greeninger* case in which he sought to distinguish it on the ground that Greeninger's deed had been procured by fraud. The answer is—as stated in our opening brief (p. 20)—that the notary had not participated in the fraud. The fact that Greeninger was entitled to rescind the deed was no part of the cause of action against the notary. The latter's false certificate was the means by which the parties guilty of the fraud were enabled to deprive Greeninger of his property. Likewise, in the case at bar the false certificate was the means by which the defendants were enabled to stop the sale. The Hill brief ignores this proposition. It is evident there is no answer.

Likewise, the Hill brief ignores the discussion in our opening brief (pp. 16-20) concerning *Heidt v. Minor*, 113 Cal. 385, 45 Pac. 700, which the learned District Judge cited in support of his theory that a false certificate is not actionable if "the underlying instrument is valid" (T. 26). As demonstrated in the opening brief, the *Heidt* case does not support this theory. The Hill brief also ignores that aspect of *Gudger v. Manton*, 21 Cal. 2d 537, 134 Pac. 2d 217, which decides that a writ of execution—valid in itself—can be used as a means of clouding title by placing it on record.

The Hill brief (p. 17) attempts to distinguish *Gudger v. Manton* on the ground that the recordation of the writ of execution created a false claim or cloud, and on the other hand, the recordation in the case at bar “merely disclosed that Barnes had contract interests affecting the property”. Here the Hill brief ignores the reason why the Supreme Court held that Gudger’s title was disparaged. The reason was that the effect of “the assertion by defendants of a claim to an interest in the property” was to discourage a prospective purchaser who “would naturally assume the plaintiff’s title was not merchantable” (quoted at pages 12-13 of our opening brief). In the case at bar Kirsch was entitled to preserve the merchantability of his title of record by withholding acknowledgment of execution before a notary. If the defendants desired to frustrate this and to cloud Kirsch’s title, they were restricted to lawful means. The use of criminal means to accomplish this result was actionable.

The brief filed by Mr. Wilkins in behalf of appellees Huber and Goodwin (herein called the Wilkins brief) seeks (pp. 3-4) to deny the felonious character of the conduct of the defendants in procuring recordation of the contract with its false certificate (Penal Code, section 115, see op. br. p. 9). This effort is based on the fact that in the past Kirsch had relied on Huber and Goodwin as his attorneys to arrange for acknowledgement of documents of title. In other words, the Wilkins brief endeavors to defend Huber and Goodwin on the theory that they could take advantage of the confidential relationship for their own ulterior purposes. Obviously, no such defense is available. The premise of Kirsch’s reliance on his attorneys was that they would obey the law—not violate it.

The Wilkins brief (pp. 12-13) refers to section 1207 of the Civil Code and contends that this case should be deemed to involve a "defect, omission or informality" which was cured one year after recordation. The answer is that the certificate was not merely defective. It was false.¹ Section 1207 is not intended to cure the consequences of a criminal act. Furthermore, the recordation occurred on September 11, 1953. At that time negotiations were pending for the sale of timber and the state was ready to close the transaction. The prevention of the sale occurred prior to the expiration of one year. Hence, sufficient time did not elapse for section 1207 to be effective.

The Hill brief (p. 15) also uses the same pretext in referring to the certificate as "defective". The same answer is applicable. The certificate was false.

3. The false certificate.

The fact that an unrecorded or unacknowledged instrument is valid between the parties has no relevancy to the issue at bar.

The Hill brief (p. 15) and the Wilkins brief (pp. 11-12) rely on the principle that an instrument which is neither acknowledged by the grantor nor recorded is nevertheless valid and binding on the parties. This proposition is not relevant. If the defendants had not recorded the contract, the sale to the state would have been promptly consummated. It was the combination of the false certificate and the recordation of the contract as a seeming encumbrance imposed by plaintiff on his title that stopped the sale and inflicted the injury.

¹The same contention appears at page 11 of the Wilkins brief, where the document is characterized as a "defectively acknowledged instrument."

The foregoing discussion serves to reply to defendants' efforts to meet the proposition that in procuring recordation of the contract by means of the false certificate the defendants were guilty of wrongful disparagement of plaintiff's title (presented in sections 6-9, pp. 8-25 of plaintiff's opening brief).

The amended complaint presents a second alternative ground. This is based on the fact that the contract was not eligible for recordation because it did not affect title or possession to real property. This point is presented in sections 10-12, pages 25-38 of plaintiff's opening brief. We proceed to reply to defendants' argument on this issue.

4. **The Hill brief disavows the basis of Judge Halbert's decision, viz.: that the contract conferred on the defendants an interest in the title to the timber.**

Judge Halbert's opinion discusses plaintiff's alternate contention that the contract did not affect title to or possession of real property and was not eligible for recordation. In Judge Halbert's opinion he held: "This contract was unquestionably one in which the right to cut, remove and market timber was transferred which is in the nature of a contract for the sale of goods" (T. 45).

The Hill brief disavows this theory. It says:

It is not important to the principle involved here to determine whether Barnes actually purchased an ownership interest in the timber, and for that reason much of the discussion contained in appellant's opening brief (pp. 35-38) is immaterial (p. 7).

The point which the Hill brief says is immaterial is the essential ground on which the District Court decided that

the contract was of such a character as to permit recordation. The Hill brief now concedes that it is unable to defend this point. Instead, it proceeds to advance the contention (pp. 7-11) that the contract affected the possession of real property. The Wilkins brief (pp. 13-14) adopts the same position. Hence, it will suffice to answer this contention and to show that the contract does not affect possession of real property.

5. The contract does not affect possession of real property.

The Hill brief asserts that the contract permits "one party to enter on certain property in which the other party has an interest" (p. 8). The Hill brief fails to quote any portion of the contract itself. Our opening brief (Sec. 11, pp. 29-32) analyzes the contract and demonstrates that the only covenant that it contains in this respect is Kirsch's agreement "to permit the timber to be logged". Furthermore, a contract permitting one party to enter on another's property does not create a right to possession of the property. The Hill brief (p. 8) cites *Western Machinery Co. v. Graetz*, 42 Cal. App. 2d 296, 108 Pac. 2d 711. There the owners of mining property leased it to operators who proceeded to enter into a contract for the rental of mining machinery. The machinery was permanently attached to the property and therefore became a part of the realty. The owners of the real property gave a trust deed as security for a loan. The lender had no knowledge of any adverse claim to the machinery. The ownerlessor of the machinery sued to recover it. His rights were held subordinate to those of the holder of the deed of trust but paramount to those of the owner of the real property. The court held that the lease of the machinery could have

been recorded and if so, it would have constituted constructive notice to the otherwise innocent encumbrancer. All that is decided in the *Western Machinery Co.* case is that leased machinery which is affixed to the realty becomes real property and for this reason the lease of the machinery came within the scope of the recording statute. Obviously, the case is not pertinent here. The Hill brief does not contain a clear statement of the case nor of the point decided. At pages 8-9 the Hill brief endeavors to construe the decision as follows:

Thus, a lease agreement providing that personal property shall retain its character as such regardless of whether it may subsequently become affixed to realty, "is an instrument affecting the title to or possession of real property" and is properly recordable.

The fact is that the provision that the machinery should continue to be personal property had nothing to do with the recordability of the lease. On the contrary, it was because as a matter of law the machinery became a part of the realty that the lease was recordable. As the result of that principle of law the lease involved title to real property. The effect of recordation would be to notify subsequent purchasers that the machinery did not belong to the owners of the real estate but to a third party and therefore, that the rights of the third party could not be eliminated by a conveyance made by such owners.

Next the Hill brief (p. 9) cites *Wayt v. Pattee*, 205 Cal. 46, 269 Pac. 660. The brief (p. 9) states that this involved a private contract "which did not create or grant any interest in or encumbrance on real property". This is not correct. The case involved restrictions as to title and pos-

session by non-Caucasians which were contained in deeds by which the owners of lots in a real estate tract had acquired their property. When the restrictions expired, the owners agreed among themselves that "we will not permit occupancy of our land or property by any person other than of the Caucasian race, and that this restriction shall be incorporated in all deeds of transfer of this property" (p. 48; p. 661). The question arose as to whether recordation of the agreement gave constructive notice of its contents to negroes who were about to acquire title to one of the lots. The court held that the agreement affected title to real property and was therefore, within the definition of "a conveyance of real property" as used in Section 1215 of the Civil Code.²

The court placed particular emphasis on the provision in the Code section concerning an instrument by which title to any real property may be affected (p. 53; p. 663).

The statement in the Hill brief (p. 9) that the instrument involved did not create any interest in real property is squarely contradicted by the decision of the court.

Next, the Hill brief (pp. 9-10) cites *Weaver v. McKay*, 108 Cal. 546, 41 Pac. 450. A brief analysis of that case will demonstrate that it is not in point. There property which was subject to mortgage was sold. The deed contained a clause that it was subject to mortgage and that the grantees assumed the obligation and the mortgage

²Sec. 1215. Conveyance defined. The term "conveyance", as used in sections twelve hundred and thirteen and twelve hundred and fourteen, embraces every instrument in writing by which any estate or interest in real property is created, aliened, mortgaged, or encumbered, or by which the title to any real property may be affected, except wills.

securing it. The mortgage was foreclosed and judgment given against the grantees of the property for the deficiency. They claimed to have been induced by fraud to accept the deed containing the clause of assumption. One of the grounds urged on appeal was that a certified copy of the record of the deed had been erroneously admitted in evidence. The basis of this contention was that the portion containing the words of assumption “was no part of the conveyance, and did not need to be recorded, and, therefore, a certified copy of the record is not evidence” (p. 549; p. 451). Rejecting this contention the court held:

The construction contended for is too narrow, but, even had the stipulation been contained in a separate instrument, it would be entitled to record under section 1158 of the Civil Code.

(p. 549; p. 451.)

Obviously, the decision is not pertinent to the issue at bar.

Next, the Hill brief (p. 10) quotes dictum from *Warnock v. Harlow*, 96 Cal. 298, 31 Pac. 166, that an instrument “transferring the title to or creating a lien on property, or giving a right to a debt or duty” is recordable. This language originated in *Hoag v. Howard*, 55 Cal. 564, cited at page 10 of the Hill brief. The holding in that case was that a writ of attachment is not an instrument eligible for recordation. It is apparent that this proposition is not pertinent to the case at bar.

In our opening brief (p. 29) answering Judge Halbert’s view that plaintiff transferred to Barnes an interest in the timber, we pointed out that the agreement provides nothing more than permission by plaintiff for the logging

operation and the designation of Barnes as general manager and that this did not constitute a transfer but merely a license (op. br. p. 34). The Hill brief (p. 10) contends that the cases above discussed "indicate" that a contract conferring such a license is eligible for recordation. The fact is that the cases contain no such intimation. To demonstrate this we need only refer to one of the cases cited at page 11 of the Hill brief—*Eastman v. Piper*, 68 Cal. App. 554, 229 Pac. 1002. According to the brief this case supports the view that "in a limited sense" a license is "regarded as an interest in land". In the *Eastman* case the court held that a license "is defined as a personal, revocable and unassignable permission or authority to do one or more acts on the land of another without possessing an interest therein" (p. 560; p. 1004). The court then distinguishes a license from an easement which "unlike a license, creates an interest in the land—an incorporeal interest" (p. 560; p. 1004).

Furthermore, the scope of the permission granted by plaintiff was expressly limited by the language of the contract, viz: "Kirsch agrees to permit the Prairie Creek timber aforesaid to be logged". The cases cited in our opening brief (pp. 25-29) demonstrate that this confers no title in the timber. By the same token it creates no right of possession. The holder of a theatre ticket has a right to attend a performance. But he has no right of possession to the building in which the performance is to take place. An agreement with a plumber for installation of bathroom fixtures in a home is a license to enter for that purpose. But his contract does not affect possession of real property.

Next, the Hill brief (p. 11) states:

Moreover, it is appellee's contention that this contract was not revocable at will, and hence not a license. However, this question is the subject of an independent appeal currently pending in this Court.

This statement evinces a misapprehension as to the issue involved in the action in which the appeal is pending (*Kirsch v. Barnes, et al.*, 15345). One of the points there presented is whether or not Kirsch was entitled to terminate the contract without subjecting himself to liability for damages. This issue is pertinent to the field of contracts—not the right of possession. A party to a contract always has the power to refuse to perform although he may be liable for damages for doing so. Barnes recovered judgment for damages and the question on appeal is whether he had a right of action for breach.

6. Plaintiff held record title to the timber and such title was by law protected against wrongful disparagement.

The Hill brief (p. 13) says that "if appellant recorded a document giving him only a personal property interest, he is in much the same position as Barnes". The Hill brief concludes that "If he (Kirsch) didn't record his document, he can't maintain this suit. If Kirsch did not have a record interest, recordation by Barnes could not have created an apparent encumbrance on his title, and could not have been the proximate cause, as alleged, of any damage to him".

The concept of placing the criminal in the same position as his victim is surely fallacious. However, plaintiff's right constituted a chattel real—"an interest akin

to a term for years'' (see Judge Halbert's opinion (T. 45) citing cases supporting this proposition). Such right to the timber was entitled to protection against disparagement.

7. The recordation of the contract was the proximate cause of the damages suffered by plaintiff.

The Wilkins brief (pp. 15-16)—under the heading: "Proximate Cause"—advances a contention the essence of which is that the recordation did not cause plaintiff any loss because the defendants could have prevented the sale by notifying the state of the existence of the contract. This contention was anticipated and answered in our opening brief (p. 10). The contract contained no description of the property other than "timber situated north of Orick, Humboldt County, California, and generally known as the Prairie Creek timber" (T. 11). The contract provided nothing more than an arrangement for logging the timber, selling the logs and dividing the proceeds. Mere knowledge of the existence of such a contract would not have deterred the state from closing the sale. The title company's policy would have contained no exception involving the contract. The record title would have been clear. Furthermore, assuming that defendants could have stopped the sale by legitimate means, this does not confer immunity upon their unlawful conduct. The Wilkins brief ignores this argument.

We conclude that on two distinct grounds a cause of action for disparagement is set forth in the amended complaint. We proceed to reply to defendants' arguments with respect to the defense of statute of limitations.

Statute of Limitations.

8. Disparagement of title constitutes an injury to real property and the period of limitation is that applicable to such an injury.

The Hill brief (p. 20) cites *Italiani v. M-G-M Corp.*, 45 Cal. App. 2d 464, 114 Pac. 2d 370. The brief concedes that *Italiani* is not concerned with an injury to real property. It was an action for “damages arising out of alleged plagiarism on the part of defendant, of a moving picture scenario which was the composition of plaintiff” (p. 465). *Italiani* contended that the period of limitation was that provided in subdivision 3 of Section 338 of the Code of Civil Procedure.³ The subdivision involves “goods or chattels”. Obviously, the act of plagiarism does not constitute a taking or injury to goods or chattels. The subdivision also applies to specific “recovery of personal property”. Obviously, damages for plagiarism cannot fall into that category. This aspect of the *Italiani* decision is clearly irrelevant to the question at bar.

The *Italiani* case proceeds to hold that the appropriate limitation with respect to a suit for plagiarism is found in subdivision 1 of Section 339 holding that the language thereof, viz.: “liability not founded upon an instrument in writing” includes “all actions at law, not specifically mentioned in some portions of the statute” (p. 467).

³The language of the subdivision which the Hill brief neglects to quote—is as follows:

3. An action for taking, detaining or injuring any goods, or chattels, including actions for the specific recovery of personal property.

Based on the foregoing ruling the Hill brief (p. 21) reaches a conclusion which is completely unjustified by the premise. The brief says:

Thus, the basic holding of the *Italiani* case is that actions for injuries to intangible or incorporeal rights, which rights may exist in connection with any piece of specific physical property, are governed by Code of Civil Procedure Section 339 (1).

There is no such decision in *Italiani*. The discussion in the opinion concerning "intangible or incorporeal rights" is a part of the reasoning by which the court concludes that the Code section concerning torts with respect to goods and chattels does not apply to "intangible or incorporeal rights." There is nothing in *Italiani* to support the contention in the Hill brief that disparagement of the title of physical real property is not an injury to real property. There is nothing in *Italiani* that throws any doubt on the proposition that such an injury to real property is covered by subdivision 2 of Section 338.

Even if there were any such decision in *Italiani*, it would be of no effect. The *Italiani* case was decided by the District Court of Appeal. No application was made for a hearing in the Supreme Court. On the other hand, *Coley v. Hecker*, 206 Cal. 22, 272 Pac. 1045 (see op. br. p. 40) was a decision by the Supreme Court of California squarely holding that slander of title constitutes "an injury to real property" and rejecting the contention of Hecker that this phrase "was intended to include only physical interference with, or physical injury to real property. . . ." (p. 27). The *Coley* case involved Section 392 concerning venue. The language "injuries

to real property'' in that section is identical in meaning with the language concerning limitation of actions, viz., ''injury to real property'' (Sec. 338, sub. 2). These words cannot mean one thing in one context and something else in another.

Hence, even if it were true—as the Hill brief contends—that *Italiani* is inconsistent with the theory of *Coley v. Hecker*, the latter would necessarily prevail because it is a ruling of the State Court of last resort. Furthermore, the Hecker case has been cited and followed in the recent decision of the California Supreme Court in *Albertson v. Raboff*, 46 Cal. 2d 375, 378, 295 Pac. 2d 405, 408 (see op. br. p. 40).⁴

The Hill brief attempts to avoid the conclusive effect of *Coley v. Hecker* on the theory that ''the court had only two alternatives, i.e., to consider the action as an injury to property or to consider it as a personal tort to the owner'' (p. 20). The significance of this statement is far from clear. What difference can the number of alternatives make? The *Coley* case defines what an injury to real property is. It decides that disparagement of title constitutes such an injury.

The same type of problem is presented at bar. This Court has the alternative of deciding whether disparagement of title is an injury to real property under section 338, sub. 2, or a tort against the owner under some other section of the statute of limitations. In view of the

⁴This case and *Smith v. Stuthman*, 79 Cal.App. 2d 708, 709; 181 Pac. 2d 123, are cited in the opening brief but neither brief of defendants mentions them.

decisions of the California Supreme Court, the choice is clear.

In further support of the contention that disparagement of title creates a "liability not founded upon an instrument in writing" (subdivision 1 of §339), the Hill brief (p. 20) states that "Section 339(1) has been defined as the California catch-all statute for miscellaneous torts. See Witkin, California Procedure Volume 1, pages 648, 649".

There is no such definition in Witkin. The language of that text states that the code section is "a catch-all for *unusual* tort actions *not otherwise provided for*". The difference between Witkin's language and that in the Hill brief is significant. Furthermore, Witkin proceeds to say that we must eliminate among others "all actions based on intentional or negligent wrongs which result in . . . injury to or loss of real property" and then points out that very few tort actions remain. The remnant does not include disparagement of title.

We come now to the contention that this action is barred by the one-year limitation applicable to slander and libel of the person.

As we have seen, *Coley v. Hecker* determines the category of injury into which disparagement of title falls. *Albertson v. Raboff*, 46 Cal. 2d 375, 379, 295 Pac. 2d 405, 408 (supra), tells us that disparagement of title falls into a different category than an action for personal defamation (App. op. br. p. 40). Consequently, the decisions in other states applying to disparagement of title the limitation applicable to libel and slander of the person (see Wilkins

br. pp. 8-9; Hill br. p. 19) can provide no assistance in the case at bar.⁵

Both the Hill brief (p. 19) and the Wilkins brief (p. 8) cite *Carroll v. Warner Bros. Pictures*, 20 Fed.Sup. 405. We shall consider this citation only because it is a federal decision. It involved the law of the State of New York where the action was commenced. The point had not theretofore arisen in that state. Therefore, the District Judge chose to follow an Ohio decision. But aside from the effect of California cases as to the nature of an action for disparagement of title (see above), the significant aspect of the *Carroll* case concerns the language of the sections of the New York Civil Practice Act as to limitation of actions. The provisions of the New York law were altogether different from those of California. Subdivision (1) of section 50 of the New York Act covers injuries to the person. But unlike California law, section 50 does not contain any reference to libel or slander. The latter subject is covered in a different section, viz. section 51. Therefore, there was no reason for interpreting the provision with respect to libel or slander as being confined to a

⁵In the appendix (p. ii) to our opening brief we quoted from subdivision (3) of section 340 the full text with respect to actions involving torts against the person. At page 40 of the brief there is an incomplete quotation which the Wilkins brief (p. 8) characterizes as "deliberately misleading". The fact that the complete text appears in the appendix and that the extract at page 40 was intended merely to show that torts involving offenses against the person—as opposed to real property—were covered by the first part of subdivision (3) should demonstrate that there was no intent to mislead.

tort against the person. The text of the New York Act is set forth in the footnote.⁶

We conclude that disparagement of title to real property is not controlled by subdivision 3 of section 340.

It is interesting to note that in 1957 the legislature eliminated any doubt as to the limitation applicable to slander of title. It added as subdivision 7 of the three year statute (C.C.P. §338) "an action for slander of title to real property". Of course, this does not control a cause of action which theretofore accrued. But in effect it has codified the pre-existing law. However, in a discussion in the State Bar Journal of September-October, 1957, p. 529, prepared by the Department of Continuing Education of the Bar of the University of California Extension, at the request of the State Bar's Committee on Continuing Edu-

⁶Gilbert-Bliss, Civil Practice of N.Y. Annotated—Book 2 recompiled.

Sec. 50. ACTIONS TO BE COMMENCED WITHIN TWO YEARS.

The following actions must be commenced within two years after the cause of action has accrued:

- (1) An action to recover damages for assault, battery, seduction, criminal conversation, false imprisonment, malicious prosecution or malpractice;
- (2) An action upon a statute for a forfeiture or penalty to the people of the state.

Sec. 51. ACTIONS TO BE COMMENCED WITHIN ONE YEAR:

The following actions must be commenced within one year after the cause of action has accrued:

- (1) An action against a sheriff or coroner upon a liability incurred by him by doing an act in his official capacity or by omission of an official duty; except for nonpayment of money collected upon an execution;
- (2) An action against any other officer for the escape of a prisoner arrested or imprisoned by virtue of a civil mandate;
- (3) An action to recover damages for libel or slander.

cation of the Bar, it is stated that an action for slander of title “formerly fell within C.C.P. §343, providing a four year statute of limitations for actions not otherwise provided for.” In other words, it was considered that the catch-all section applicable to such an action was Section 343 of the Code of Civil Procedure. This theory is open to question in view of *Coley v. Hecker*, and subsequent decisions to the same effect. But it confirms plaintiff’s contention that the applicable period of limitation is not one year nor two years.

For the reasons above stated the action which was commenced on November 30, 1956 was not barred.

9. Slander of title, based on the recordation of a false document, is a continuing tort.

This point providing an additional answer to the defense of limitations is discussed at page 41 of our opening brief. The proposition and the cases cited are ignored in both the Hill brief and the Wilkins brief. Therefore, no further discussion is necessary.

10. By reason of the confidential relations between the parties and defendants’ concealment of their conduct the statute of limitations was tolled until Kirsch discovered the fact that a false certificate had been attached to the contract. Therefore, regardless of which section of the Code is applicable, the action is not barred.

The Hill brief (p. 22) states: “Appellant nowhere specifically alleges when he first became aware of the false acknowledgment” (Also at page 3).

Apparently, the writer of the Hill brief has failed to read paragraph VII of the amended complaint. The last subparagraph reads:

Defendants concealed from plaintiff and plaintiff did not know or discover that said certificate had been falsely made and attached to said contract until the occurrence of the events in February, 1956, hereinafter set forth (T. 34-35).

A subsequent paragraph of the pleading contains the allegation as to the confession of the fraud at the trial of the prior action in February, 1956.

The Wilkins brief (p. 4) admits that the amended complaint contains the allegation quoted above. It proceeds to refer (p. 4) to another allegation that "if plaintiff had received the purchase price on July 27, 1954, he could and would have invested the same" (T. 40). Then the Wilkins brief contends (pp. 4-5):

. . . it is the only possible inference that by July 27, 1954, at the least, appellant had *actual* knowledge that the contract had been recorded and knew that a certificate of acknowledgment had been attached thereto. (*italics* quoted).

The answer is that no such inference can be drawn. The allegation as to what plaintiff could have done with the funds if available is not pertinent to the matter of discovery. It relates only to the issue of damages. It is premised on the hypothesis that there was no false certificate and that the sale had been completed according to plan. The allegation does not contain the slightest intimation with respect to the subject of discovery.

Apparently, what the writer of the Wilkins brief has in mind is that when the state refused to close the sale, this circumstance and the reason for the refusal eventually

came to plaintiff's attention. On the assumption that at that time plaintiff became aware of the recordation of the contract, the Wilkins brief (pp. 4-5) says that from this we must infer that plaintiff acquired actual knowledge of the fact "that a certificate of acknowledgment had been attached thereto". The answer is first, that actual knowledge of the contents of the document on record could only be obtained by examining the record and plaintiff did not do this. Second, plaintiff was not presumed to know that a certificate of acknowledgment was required in order to record the contract, or a fortiori, that a certificate of his own acknowledgment was necessary. Therefore, plaintiff did not even have implied knowledge of the attachment of the certificate. Third, plaintiff was not obliged to cudgel his memory in order to recall the circumstances of his signature to the contract approximately two years before and to realize that a false certificate must have been attached.

Then the Wilkins brief (p. 5) says:

Apparently it is his (plaintiff's) contention that concealed facts of some nature or another, were revealed at the trial of February 1956, and that by reason of this revelation he "discovered" that the certificate of acknowledgment had been "falsely" made. Up to February 1956, appellant regarded the certificate of acknowledgment as being in order. He did not object or complain that such acknowledgment was "false".

The answer is first, that the concealed facts were not "of some nature or another". They were specific, viz: the certificate of acknowledgment had been attached a week after the contract had been signed and that this had been

procured by Barnes in cooperation with employees of Huber & Goodwin (Am. Comp. Par. VIII, T. p. 36).

Second, the statement in the Wilkins brief quoted above that prior to this revelation "appellant regarded the certificate of acknowledgment as being in order" is without foundation. Until so apprised by Barnes' testimony at the previous trial plaintiff had no knowledge that any certificate of plaintiff's acknowledgment was in existence.

The Wilkins brief (p. 5) then propounds this rhetorical question:

What "concealed facts" were revealed to appellant at the trial of February 1956?

The answer—as above stated—is the attachment of the false certificate on October 23, 1952 at the instance of Barnes. But the Wilkins brief ignores this. Instead, it refers to the difference between Kirsch's and Huber's recollection as to the place where Kirsch signed the contract. This is not the significant aspect of the discovery. It is merely one more reason why the delay in the sale did not excite any suspicion in Kirsch's mind. But once Barnes gave his testimony as to the attachment of the false certificate, it made no difference whether the recollection of Kirsch or Goodwin as to the place of signature was correct.

The Wilkins brief (p. 5) contends: "Appellant, of course, had constructive knowledge of the recording on September 11, 1953 (T. 37)". The answer is found in the allegation of the amended complaint, paragraph IX (at pp. 37-38) that Barnes surreptitiously and for the purpose of impeding the sale to the State procured the recordation

of the contract and concealed the recordation from plaintiff. The rule as to constructive notice of a recorded document applies to subsequent purchasers. Furthermore, there was a fiduciary relationship between the parties. The effect thereof is decided in *Bennett v. Hibernia Bank*, 47 Cal. 2d 540, 305 Pac. 2d 20 (op. br. pp. 43-44), viz:

In view of the allegations indicating that a fiduciary relationship existed, the fact that a document disclosing these events was a matter of public record filed with the Secretary of State cannot alone cause the statute to run.

.

The documents filed in that year, while public records and constructive notice for certain purposes, are not sufficient to start the running of the statute in favor of the fiduciary as to those of its members who had no knowledge of them (p. 562; p. 34).

Both the Wilkins and Hill briefs ignore the *Bennett* case and the principle therein set forth.

11. **The date on which Kirsch could have commenced suit if he had known of the false certificate is immaterial. The determinative date is when the fraud was discovered.**

The Hill brief (p. 23) relies on the fact that Kirsch sustained damage on the date when the state would have closed the sale if the contract had not been recorded. This was July 27, 1954. Then the Hill brief concludes that Kirsch's cause of action accrued on that date and implies—but does not expressly say—that the statute of limitations began to run.

This argument ignores the principle that where a confidential relationship exists, concealment tolls the statute

and the wrongdoer is estopped from taking advantage of it. This proposition and the California decisions supporting it are discussed at pages 42-44 of our opening brief. The subject is not even mentioned in either the Hill or the Wilkins brief. Likewise, there is no mention of the decisions.

The Wilkins brief (p. 7) contends:

The complaint must set forth *specifically*, (1) the facts of the time and manner of discovery, and (2) the circumstances which excuse the failure to have made an earlier discovery.

The answer is that the cases cited in our opening brief (pp. 42-44)—and ignored by appellees—hold that in a case of confidential relationship “a plaintiff need not disprove that an earlier discovery could have been made upon a diligent inquiry but need show only that he made an actual discovery of hitherto unknown information within the statutory period before filing the action” (*Bennett v. Hibernia Bank*, 47 Cal. 2d 540, 564, 305 Pac. 2d 20, 35). Furthermore, there are allegations in the amended complaint amply explaining why Kirsch’s suspicion was not aroused until the falsity of the certificate was revealed at the trial.

The foregoing suffices to answer the contention in the Hill brief (p. 23) involving the date of July 24, 1954. But in passing it should be noted that the Hill brief is in further error. It states (p. 23) that plaintiff “sustained damage on that date, which damage consisted of loss of a sale”. The fact is that the sale was not lost. It was delayed. The damage resulted from postponement of the

receipt of the price and the imposition of taxes in the interim⁷ (T. 40). Hence, the damage only began on July 24, 1954. It continued until Kirsch yielded to the demands of defendants for the escrow of funds and was able to consummate this arrangement (T. 39).

For the additional reasons above stated the action was not barred.

Dated, San Francisco, California,
September 29, 1958.

DAVID LIVINGSTON,
JAMES R. MANSFIELD,
Attorneys for Appellant.

⁷The Wilkins brief (pp. 16-18) contains the same misconception of plaintiff's damages, contending that the sole measure of recovery is the diminution of value of the property as the result of the disparagement. The answer is found in the allegations of the amended complaint specifically stating the items of plaintiff's loss.

No. 15892

**In the United States Court of Appeals
for the Ninth Circuit**

M. H. SHERMAN COMPANY, A CORPORATION, APPELLANT

vs.

UNITED STATES OF AMERICA, APPELLEE

*Appeal from the United States District Court
for the District of Arizona*

BRIEF FOR M. H. SHERMAN COMPANY, APPELLANT

**GUST, ROSENFELD, DIVELBESS
& ROBINETTE**

By **FRANK E. FLYNN**
Phoenix, Arizona

FILED

APR 14 1958

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In the United States Court of Appeals for the Ninth Circuit

No. 15892

M. H. SHERMAN COMPANY, A CORPORATION, APPELLANT

vs.

UNITED STATES OF AMERICA, APPELLEE

*Appeal from the United States District Court
for the District of Arizona*

BRIEF FOR THE APPELLANT

JURISDICTION

The Amended Complaint alleges that the Government having leased certain property from the plaintiff erected buildings thereon, including concrete floors, foundations, slabs, swimming pool, tennis court and other concrete structures. That at the termination of the lease when the government removed the buildings, it failed to remove the concrete structures and that plaintiff was damaged thereby to the extent of the cost of removal.

The jurisdiction of the District Court was invoked under Title 28 U.S.C., Section 1346b (R 9).

Judgment in favor of the defendant was entered and filed December 31, 1957 (R 26); Notice of Appeal and Bond on Appeal were filed January 6, 1958 (R 26). The jurisdiction of this court rests on Title 28 U.S.C., Sec. 1291.

NOTE: Figures appearing after the letter R refer to pages of the Transcript of Record.

STATEMENT OF THE CASE

The facts in this case are undisputed and have been stipulated to (Plaintiff's Exhibit 1). The allegations of paragraphs 1, 3 and 4 of the Amended Complaint are admitted (R 31) and by the stipulation, plaintiff's Exhibit 1, it is stipulated that the plaintiff, a California corporation, was duly qualified to do business in the State of Arizona and at all the times involved was the owner of the land leased to the Government and described in the certified copy of the Complaint (R 9). That the lease remained in force until October 27, 1952, when it was terminated as the result of Presidential Proclamation of April 28, 1952 (paragraph 4 of Complaint) (R 10).

The defendant entered into possession of the premises and erected structures and buildings thereon including concrete platforms, floors, footings, a swimming pool and tennis court. That at the termination of the lease when defendant removed the buildings, the concrete part of the structures mentioned were not removed (Plaintiff's Exhibit 1). (R 31)

It was also stipulated that the diminution in the value of the premises by reason of the presence of the concrete structures would be the cost of removal which is agreed would be \$17,500.00 (Plaintiff's Exhibit 1) (R 32).

On December 31, 1957, the court made its Findings of Fact in which it found the facts as above stated (R 22-24).

As conclusions of law the court found that:

1. The court has jurisdiction of the subject matter and the parties.
2. The lease specifically relieves the defendant from any duty to remove buildings or structures (R 24).

On December 31, 1957, Judgment was entered in favor of the defendant and against the plaintiff. Thereafter timely notice of appeal was given and bond filed (R 26-27).

ISSUES INVOLVED

The main issue involved is whether or not the government when it removed the buildings from the premises at the termination of the lease owed a duty to the plaintiff to remove the concrete floors, platforms, and other concrete structures, and whether or not the Government would be liable to the plaintiffs for the damages to the premises as a result of the concrete structures being left on the property.

SPECIFICATIONS OF ERROR

1. The court erred in its conclusion of law that the lease specifically relieved the defendant of any duty to remove buildings or structures from the leased premises. This conclusion of law is erroneous for the reason that it is not a correct construction or interpretation of the provisions of the lease and for the further reason that independent of the terms of the lease the Government owed a duty to the plaintiff to use the property so as not to damage the property or injure the inheritance and for the further reason that the conclusion of law is not justified by the evidence

or by the Findings of Fact and fails to take into consideration that part of the structures were removed by the Government.

2. The court erred in entering Judgment in favor of defendant and against plaintiff for all of the reasons set forth in Specification No. 1.

ARGUMENT

The Government is relying on paragraph 12 of the lease to relieve it from liability in this case. Paragraph 12 reads as follows:

“12. A joint survey and inspection of the conditions of the within-described premises has been made and reveals the property to be unimproved desert land, on which there are no physical improvements, and the lessor agrees to the foregoing statement and hereby relieves the Government of any and all restoration responsibility resulting from the use of the subject lands by the Armed Forces.” (R 38)

In construing this paragraph it is necessary to take into consideration other provisions of the lease. This was a lease of approximately one hundred seventy-five (175) acres at a nominal annual rental of \$85.00 for the following purposes: “requirements of the war department.” (R 35) The lease was on a regular Government printed form and contained the following provisions in paragraph 8:

“8. The Government shall have the right, during the existence of this lease, to make alterations, attach fixtures, and erect additions, structures or signs, in or upon the premises hereby leased (provided such alterations, additions, structures, or signs shall not be detrimental to or inconsistent with the rights

granted to other tenants on the property or in the building in which said premises are located); which fixtures, additions, or structures so placed in or upon or attached to the said premises shall be and remain the property of the Government and may be removed therefrom by the Government prior to the termination of this lease, * * * ." (R 36-37)

At the termination of the lease the Government under the provisions of paragraph 8 removed buildings from the premises but failed to remove the concrete floors, abutments, and other concrete structures. This we submit constituted a tortious act on the part of the Government and a violation of a duty it owed the plaintiff arising out of the contract and irrespective of the terms of the lease. That the damages to the plaintiff as a result of this failure on the part of the Government was in the sum of \$17,500.00.

It is claimed by the Government that paragraph 12 of the lease relieves the Government of the duty of removing the concrete. The fact that there was a contract between the parties does not necessarily mean that an action in tort cannot be brought for damages suffered by plaintiff by reason of the acts of the defendant. Agreements exempting persons from liability for negligence induce a want of care and for that reason no one should be permitted to contract against his own negligence.

12 Am. Jur. 683-684, paragraph 183.

This same authority says, however, that while the foregoing rule has been relaxed it still applies where the parties do not stand on equal footing or equality.

In the present case we have the government on one side and a private corporation on the other side en-

tering into a contract vitally affecting the defense activities of the government in time of a national emergency. It would seem under those circumstances that as a matter of justice and equity, any provision of the lease relieving the government from responsibility for damage to the property would be required to be set out in definite unmistakable and understandable terms. We respectfully submit that a provision relieving the government from restoration responsibility, of desert land, resulting from the use of such land by the Armed Forces is not sufficiently clear and unambiguous to constitute permission to destroy the use of the land for all practical purposes.

The crucial question in this case is whether, independent of the express provisions of the contract, which are relied upon by the defendant, the Government owed a duty to use its best efforts to use the leased property so as not to damage the property or injure the inheritance.

HARPER vs. INTERSTATE BREWERY COMPANY, 120 P. 2d 757. We quote from the opinion in that case:

“Thus it may be necessary for a plaintiff to show a contract between himself and the defendant in order to establish that the defendant has assumed a position, relationship or status upon which the general law predicates a duty independent of the terms of the contract but it does not necessarily follow that his only remedy is ex contractu. If from the position, contractually assumed, a duty be raised independent of the contract an action in tort may lie. * * * A mere breach of contract cannot be sued on a tort, but for tortious acts, independent of the contract, a man may be sued in tort, *though one of the consequences is a breach of his contract.*” (Emphasis supplied)

We will not quote further from the above authority but we respectfully call the court's attention to page 762 of the opinion where the court discusses the distinction between a tort and a breach of contract. The opinion contains many quotations from leading authorities. All are to the effect that causes of action need not be completely disconnected from contracts in order to constitute torts.

In all leases the covenant to deliver up the premises at the expiration of the lease in as good condition as when taken over by the tenant, reasonable wear and tear excepted, is the implied duty resting on the tenant.

32 Am. Jur., page 690, Sec. 811.

Any exception to this implied obligation is a modification of the common law rule and should be construed in favor of the landlord. This principal of construction particularly applies in this case where it is apparent that the lease is on a prepared government form and obviously prepared by the Government.

12 Am. Jur. 795, paragraph 252.

Another rule of construction applicable to this case is that where terms of a contract would appear on their face to be inserted for the benefit of one of the parties they will be construed as having been inserted by him and therefor in case of ambiguity will be construed against him.

17 C. J. S. 755.

The premises in the present case were leased to the Government for \$85.00 per year, a nominal rent, in-

dicating that the real consideration was a desire to aid the Government in its war efforts. We mentioned this for the purpose of showing why the contract and the corresponding rights and duties of the parties should be construed strictly against the Government.

Paragraph 12 is an exception to the usual obligation of a lessee and therefore its meaning should not be extended and its application should be strict and literal.

Paragraph 8 of the lease above quoted obviously applies to improved property when it provides that the Government may make alterations, attach fixtures, additions, and structures to the buildings. The paragraph also provides that such fixtures, alterations, etc. shall remain the property of the Government and may be removed. Having elected to remove the structures placed upon the premises by the defendant, it was the duty of the Government to remove the entire structure. There would be no salvage value in the concrete slabs and therefore the Government failed to remove them and without the buildings the concrete slabs were of no use to the premises and had no value. It was this act on the part of the Government of which plaintiff complains. The cement rendered the premises unfit for farming, subdivision purposes, or for any other purpose for which land of that nature might be used. On the contrary, they would have to be removed if the premises were to be used for any of the above purposes.

By the terms of paragraph 12 it was agreed that the premises were "unimproved desert land on which there are no physical improvements." (R 38) All this quoted clause of paragraph 12 means is that there were no improvements on the premises when the defendant

took possession and that therefore the only thing to be restored would be the desert growth. This we admit the Government was not required to do.

We respectfully submit that the provisions of paragraph 12 of the lease cannot be construed to relieve the Government from all responsibility for damage to the premises. For all practical purposes the land was destroyed and could not be used for any of the purposes that it might have been used for before it was taken over by the Government without the expenditure of \$17,500.00 for the removal of the concrete.

Before there can exist a right for destruction without an obligation to reconstruct, the language and intent must plainly and unmistakably so provide. We submit that paragraph 12 cannot be expanded to that extent.

The word "restore" relates to something having previously existed.

VOLUME 37A, Words And Phrases, page 70.

"Remove" means to "remove from a position occupied".

VOLUME 36, Words and Phrases, page 852.

Irrespective and independent of the terms of the lease there was an implied obligation on the part of the Government to treat the leased property in such manner that no injury be done to the inheritance.

U. S. vs. BOSTWICK, 94 U. S. 53, 24 Law Ed. 65
U. S. vs. JORDAN, 186 Fed. 2d 803

In the Jordan case the land had been leased to the Government for air to ground gunnery. The presence of steel jacketed machine gun bullets in the standing timber rendered the timber valueless. The land was acquired by the Government for temporary use partly through leases and partly through condemnation actions. In the condemnation suit the government secured from the land owner an agreement stipulating to the fair rental value of the property and land owner agreed to accept said sum in full and complete satisfaction for the land and release the United States from any and all claims for damages and in the leases taken from the land owners the United States was released from all claims excepting unpaid rent. The trial judge set aside the judgment entered on the stipulation on the ground that they were manifestly unconscionable and ruled that the claimants were entitled, in addition to the rental value, to recover just compensation for the taking of their growing timber. The Circuit Court held that even in the absence of an express covenant as was the situation in the condemnation suits, there is an implied obligation on the part of the lessee to treat the property leased in such manner that no injury be done to the inheritance.

It is our position that paragraph 12 of the lease does not cover and was not intended to cover damages caused by the negligence or tortious acts of the Government.

UNITED STATES vs. KELLY, 236 Fed. 2d 233

This case arose in South Dakota where the plaintiff Kelly purchased garbage from the Veterans' Hospital at Hot Springs. The contract contained a provision that the property was offered "as is" and without recourse against the government as follows:

“The government makes no guaranty, warranty, or representation, expressed or implied, as to the quantity, kind, character, quality, weight, size or description of any of the property or its fitness for any purpose and no claim shall be considered for allowance or adjustment or for rescission of the sale based upon the failure of the property to correspond to the standard expected; this is not a sale by sample.”

Several of the plaintiff's cattle had access to this garbage which had been contaminated by the employees at the hospital and the court found that the garbage contained lead and was poisonous and caused the deaths of plaintiff's cattle. The Government relied for defense on the provision of the contract, part of which is quoted above. We quote from the opinion of the circuit court in reference to the above paragraph:

“The trial court declared in its opinion that the paragraph does not cover and was not intended to cover liability for negligence of the defendant and we are in accord with that declaration * * * * .”

The reasoning in the Kelly case is applicable to the present case.

CONCLUSION

We have here the situation of the plaintiff turning over to the government approximately one hundred seventy-five acres of land for the use of the War Department. This land was unimproved desert land and it would obviously be necessary, before the land could be used for the purposes for which the Government required it, to remove the desert growth and necessarily change the contour of the land to some extent. To do this would require excavating and filling before buildings could be erected. To return the land in its orig-

inal condition at the expiration of the lease would be difficult if not an impossible task. It was to avoid this situation that the provisions of paragraph 12 were adopted.

It is admitted that by leaving the concrete structures on the premises damages in the amount of \$17,500.00 has resulted. This, it seems to us, is a severe penalty to impose upon the plaintiff for its cooperation with the Government in time of an emergency. When the buildings were removed by the Government, the concrete footings and floors remaining were valueless and their usefulness was destroyed.

We respectfully submit that in all fairness and as a matter of law this case should be remanded with directions to enter judgment in the sum of \$17,500.00 in favor of plaintiff.

Respectfully submitted,

GUST, ROSENFELD, DIVELBESS
& ROBINETTE

By FRANK E. FLYNN

Attorneys for Appellant

APPENDIX

Plaintiff's Exhibit 1 appears in the Transcript of Record at pages 31 through 50, inclusive.

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NO. 15892

IN THE
United States
Court of Appeals
For the Ninth Circuit

M. H. SHERMAN COMPANY,
a corporation,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court
for the District of Arizona

BRIEF OF APPELLEE

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UNITED STATES OF AMERICA,

Appellee.

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for the District of Arizona

BRIEF OF APPELLEE

JURISDICTION

The Government has from the inception of this case denied that the District Court had jurisdiction of the case, and it is still the contention of the Government that this action was not properly brought in the District Court. The reasons for attacking jurisdiction of the District Court will be set out more fully in a subsequent portion of this brief.

STATEMENT OF THE CASE

This action was commenced by a complaint filed in the District Court on October 5, 1954, and after the Government's motion to dismiss had been granted the amended complaint was filed on October 27, 1955, some three years after the expiration of the lease in question.

The essential facts of the case were stipulated for trial, and the District Court found for the Government on the merits.

ISSUES INVOLVED

The issue on the merits is whether the Government, under the terms of the lease, was required to remove improvements from appellant's land.

On the jurisdictional issues the questions presented are whether this type of action can properly be maintained under the Tort Claims Act and whether, if so maintainable, the amended complaint was within the period of the Statute of Limitations provided by the Tort Claims Act.

ARGUMENT

Appellant, plaintiff below, claims at page 5 of its brief that the action of the Government in failing to remove additions and structures from appellant's land . . . "constituted a tortious act on the part of the Government and a violation of a duty it owed the plaintiff arising out of the contract and irrespective of the terms of the lease."

Appellant has not cited any authority for the proposition that the Government had a duty irrespective of the terms of the lease to remove improvements from the land which were placed thereon under the specific authority of the lease. In fact, the rule is that the lessee is not required to remove improvements made by him with the consent of the landlord or under the authority of the lease in the absence of express requirement by the lease.

36 Corpus Juris, pp. 199-200, par. 864.

51 C.J.S., p. 1157, par. 408.

It is true that the tenant must not commit or suffer waste of the freehold. But waste in this real property sense is described as an abuse or destructive use of

property by one in rightful possession; it may be voluntary waste which is an active or positive act of spoliation or destruction of the freehold, or it may be a failure to exercise due care in the protection of the freehold, such as allowing buildings to fall for want of repair.

56 Am. Jur., p. 452, par. 4.

Black's Law Dictionary, 4th Edition, p. 1760.

A lease agreement may permit or authorize acts or conduct which would normally constitute waste. Every lease agreement which allows the tenant to make changes or additions to the land permits waste in a limited sense.

56 Am. Jur., pp. 453-455, pars. 7 and 9.

The acts of the Government did not constitute waste, for the lease allowed the improvements to be placed on the land (Lease, par. 8, TR. 36). In order for an action for waste to lie, the acts must involve the action or failure to act of the tenant in possession. Appellant does not claim that the Government committed any unauthorized act during the term of the lease; hence, the real property action of waste does not lie in this case.

Appellant cites authority dealing with the question of negligence and the effects of contracts to relieve persons of their negligent acts. *United States v. Kelley*, 236 F. 2d 233. But appellant confuses contracts to avoid liability for negligence with contracts to allow a tenant to use land in a certain manner. The former type of contracts are not favored in the law, but the latter type of contracts are approved even though a tenant's acts would otherwise constitute waste.

56 Am. Jur., p. 455, par. 9.

Thus authorities on negligence have no place in this case, for there certainly is no question of common negligence involved.

The original improvements were placed on the land by the express authority of the lease. (Paragraph 8, TR. 36-37.) The lease did permit the Government to remove improvements, but nothing in the lease stated that the improvements had to be removed. The very terms of the lease gave the Government the continuing right to make, alter, and erect structures on the land during the period of the lease. There is no claim or showing that either voluntary or permissive waste was committed by the Government during the period of the lease, and the leaving of the improvements on the land is not waste as the authorities consider and define it.

The standard form lease used by the Government in this case did have a restoration clause as part of paragraph 8, but this section was deleted by the parties. The section deleted read:

... , "and the Government, if required by the Lessor, shall before the expiration of this lease or renewal thereof, restore the premises to the same conditions as that existing at the time of entering upon the same under this lease, reasonable and ordinary wear and tear and damages by the elements or by circumstances over which the Government has no control, excepted. Provided, however, that if the Lessor requires such restoration, the Lessor shall give written notice thereof to the Government days before the termination of the lease." (TR. 37)

To the lease was added the provisions of paragraph 12:

"A joint survey and inspection of the conditions of the within-described premises has been made and reveals the property to be unimproved desert land, on which there are no physical improvements, and the lessor agrees to the foregoing statement and hereby relieves the Government of any and all restoration responsibility resulting from the use of the subject lands by the Armed Forces." (Tr. 38)

The lease must be read as a whole to determine the intent of the parties, and considering the lease as allowing the placing of improvements on the land, deleting a restoration clause, and inserting a clause which stated that the Government was relieved of all restoration responsibility resulting from the use of the land could only mean what its unambiguous terms implied, namely, that the Government did not have any restoration responsibility, that is, it did not have to remove the improvements it might place on the land.

United States v. Jordan, 186 F. 2d 803, cited in appellant's brief, is not authority against the Government's position, and in fact it tacitly admits that the Government may contract to relieve itself of any possible restoration damages in its use of land. The *Jordan case* involved both leased land and condemned land, and the Court held that: "The releases and stipulations, together with the judgments entered on the stipulations, were properly set aside as being based on a mutual mistake of fact." This mistake arose due to both parties being unaware of hidden defects in the timber on the land which made it unmarketable. But in our case there is no showing of any mutual mistake. The lease agreement provided that additions and structures could be placed on the land, so the parties knew that such use was contemplated, and in the same lease agreement the parties agreed to delete a clause which required restoration of the premises, and instead the parties inserted a clause which exempted the Government of *any and all* restoration responsibility.

While appellant emphasizes the cost of removing the improvements from the land, there is not a murmur concerning the great increase in value which time and circumstances have added to this once desert land. This increase in value will easily compensate for the cost of removing improvements and still leave a handsome return on appellant's speculation.

JURISDICTIONAL MATTERS

The Complaint originally filed in this action alleged a claim for relief consistent with a claim under the Tucker Act (28 U.S.C. 1346(a)(2)), but the claim, being in excess of \$10,000, was beyond the jurisdiction of the District Court. The Government's Motion to Dismiss was granted, but on the basis that appellant had failed to comply with Rule 8 by alleging the grounds for Federal Jurisdiction (TR. 24). Leave to amend was granted at the time the Complaint was dismissed. It is the contention of the Government that the original Complaint alleged a contract action, and due to the amount of the claim, the District Court was without jurisdiction. Thereafter, appellant amended its complaint to seek relief under the Tort Claims Act.

Appellant was hard pressed to avoid the clear indication that this entire case was at most a contract action, and the appellant is still not clear as to whether his action is one based on waste or negligence, but the type of action alleged in the original complaint was one in contract.

It is, of course, basic that no suit may be brought against the sovereign without specific statutory consent, and when suits are authorized, they must be brought only in the designated courts.

United States v. Shaw, 309 U.S. 495, 500.

Statutes which waive immunity of the United States from suit are to be strictly construed in favor of the sovereign.

McMahon v. United States, 342 U.S. 25, 27.

Appellant amended its complaint after the Government's Motion to Dismiss had been granted, and the amended Complaint claimed jurisdiction under the Tort Claims Act. 28 U.S.C. 1346(b). It is the contention

of the Government that the type of action alleged in the Amended Complaint was not properly maintainable under the Tort Claims Act. The last mentioned act was meant to provide a remedy for those who had been without one.

Ferres v. United States, 340 U.S. 135, 140.

In this case appellant had a remedy under the Tucker Act, and this remedy had been in use for years before the Tort Claims Act came into existence.

United States v. Bostwick, 94 U.S. 53.

As a result of the facts proved in the case, the Government believes that the Tort Claims Act was shown not to be applicable to the case because no tortious conduct was proved.

It is clear from the record that the Amended Complaint was filed three years after the cause of action arose, and unless the Amended Complaint relates back to the original filing of the Complaint the Statute of Limitations of two years had expired. 28 U.S.C. 2401(b).

The Statute of Limitations in the Tort Claims Act is more than mere procedure. It is a matter of compliance with the terms of the statute as a condition precedent to maintenance of the action.

Simon v. United States, 244 F.2d 703.

When the original Complaint was filed, the District Court did not secure jurisdiction as the action was under the Tucker Act and beyond the District Court's jurisdictional amount. By the time the Amended Complaint was filed the Statute of Limitations had already run, and the rule is that the Amended Complaint cannot relate back to the date of the filing of the original Complaint when the Court did not have jurisdiction of the original complaint.

Hammond-Knowlton v. United States, 121 F. 2d 192.

Dell v. American Export Lines, 142 F.S. 511 at 513.

Nor is the result changed by the liberal relation back doctrine of amendments provided by the Federal Rules of Civil Procedure. These rules apply when the District Court has jurisdiction, and until the court has jurisdiction the rules of procedure have no application.

United States v. Sherwood, 312 U.S. 584, 591.

CONCLUSION

The Government believes that the District Court was correct in the decision on the merits of the case, but despite the favorable decision on the merits, the importance of the jurisdictional issues involved in this case require that those issues be presented to this Court.

The Government respectfully urges that from the law and facts applicable to the case, the decision of the District Court should be affirmed or in the alternative that the action be dismissed for lack of jurisdiction.

Respectfully submitted,

JACK D. H. HAYS,

United States Attorney

WILLIAM A. HOLOHAN,

Asst. United States Attorney

204 United States Court House

Phoenix, Arizona

No. 15892

United States
Court of Appeals
for the Ninth Circuit

M. H. SHERMAN COMPANY, a Corporation,
Appellant.

vs.

UNITED STATES OF AMERICA,
Appellee.

Transcript of Record

Appeal from the United States District Court for the
District of Arizona

FILED

MAR 12 1958

PAUL P. O'BRIEN: CLERK

No. 15892

United States
Court of Appeals
for the Ninth Circuit

M. H. SHERMAN COMPANY, a Corporation,
Appellant.

vs.

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Transcript of Record

Appeal from the United States District Court for the
District of Arizona

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ATTORNEYS OF RECORD

GUST, ROSENFELD, DIVELBESS & ROBIN-
ETTE,

FRANK E. FLYNN,
Security Building,
Phoenix, Arizona,

Attorneys for Appellant.

JACK D. H. HAYS,
United States Attorney;

WILLIAM A. HOLOHAN,
Assistant United States Attorney,
United States Courthouse,
Phoenix, Arizona,

Attorneys for Appellee.

United States District Court for the
District of Arizona

Civ-2078 Phx.

M. H. SHERMAN COMPANY, a Corporation,
Plaintiff,

vs.

THE UNITED STATES OF AMERICA, a Body
Politie, Corporate, and Sovereign,
Defendant.

COMPLAINT

The Plaintiff Complains of the Defendant and
for Cause of Action Alleges:

I.

That the Plaintiff is now and at all times herein
mentioned has been a corporation, organized and ex-
isting under and by virtue of the laws of the State
of California.

II.

That Defendant is now and at all times herein
mentioned has been a body politic, corporate and
sovereign.

III.

That the Plaintiff is now and at all times herein
mentioned has been the owner in fee of the following
described real property situated in the County of
Maricopa, State of Arizona, to wit:

That part of the West Half ($W\frac{1}{2}$) Section
Thirty-four (34), Township Two North (T2N),

Range Four East (R4E), Gila and Salt River Base and Meridian, lying West of the cross-cut canal Except a parcel approximately 150 feet by 150 feet in the Northwest corner thereof, Maricopa County, Arizona, containing approximately 175 acres of unimproved Desert Land.

IV.

That on or about the 16th day of May, 1943, said Plaintiff and said Defendant entered into a written lease dated the 16th day of May, 1943, whereby the said Plaintiff, as Lessor, leased to the said Defendant, as Lessee, to be used by the lessee for the requirements of the War Department, said real property for the period beginning with the 16th day of May, 1943, and ending with the 30th day of June, 1943, with the provision that said lease at the option of the Lessee be renewed from year to year and, by supplemental written agreement dated June 23, 1943, made between said Lessor and said Lessee, the term of said lease was extended for the period beginning July 1, 1943, through June 30, 1944, with the provision that unless and until Lessee shall give to Lessor 30 days advance written notice of cancellation of said lease, the said lease shall remain in force thereafter from year to year without further notice and with the further provision that said lease shall in no event extend beyond six months from the date of the termination of the unlimited national emergency as was declared by the President of the United States on May 27, 1941 (Proclamation 2487), and that the term of said lease expired on October 27, 1952, as a result of Presiden-

tial Proclamation No. 2974 of April 28, 1952, terminating such unlimited national emergency, and the expiration of six months thereafter.

V.

That upon the execution of said lease, the defendant entered into the possession and occupancy of said premises and established thereon a military camp for the quartering of soldiers and for other military activities, and erected thereon many wooden barracks, bath houses, latrines, and other accessories and other appurtenant buildings, with concrete foundations, floors, slabs, platforms and other appurtenances, and other concrete structures, or parts of structures, and underground pipes, a concrete swimming pool and a tennis court with a hard-surface pavement, and the Defendant at the termination of said lease failed and refused, and still fails and refuses, although demand has been made upon it so to do, to remove from said premises the concrete of the said floors, foundations, slabs, platforms, swimming pool, and other structures and appurtenances and the said pipes and the hard surface of said pavement of said tennis court, and has thereby committed waste on said premises to the great injury and damage of the said premises and of Plaintiff's reversionary interest, estate and inheritance in said premises and to the injury and damage of the Plaintiff in the sum of Forty Thousand Dollars (\$40,000.00), which is the reasonable cost of the excavation and removal from said premises of all thereof.

Wherefore, Plaintiff prays for judgment against said Defendant as follows:

1. For the said sum of Forty Thousand Dollars (\$40,000.00).
2. For Plaintiff's costs and disbursements herein.
3. For such other and further relief as to the Court shall seem proper.

GUST, ROSENFELD,
DIVELBESS & ROBINETTE,

By /s/ IVAN ROBINETTE,
Attorneys for Plaintiff.

Duly verified.

[Endorsed]: Filed October 5, 1954.

[Title of District Court and Cause.]

MOTION TO DISMISS

Now Comes United States of America, by Jack D. H. Hays, United States Attorney for the District of Arizona, and Everett L. Gordon, Assistant United States Attorney for said District, and moves that the above-entitled cause be dismissed upon the ground of lack of jurisdiction.

JACK D. H. HAYS,
United States Attorney
for the District of Arizona.

/s/ EVERETT L. GORDON,
Assistant U. S. Attorney.

This Motion is based on the provisions of Title 28 U.S.C. 1346, which sets forth the jurisdiction of the District Court with regard to the United States as a defendant. Pursuant to sub-paragraph a(2) of the afore-cited section, it is stated that the United States District Court has jurisdiction of claims against the United States not exceeding \$10,000.00 in amount.

As the Court well knows, a sovereign can only be sued if it consents to suit, and then such actions must be brought under the strict letter of the statute.

Respectfully submitted,

JACK D. H. HAYS,

United States Attorney for the District of Arizona,
and

EVERETT L. GORDON,

Assistant U. S. Attorney;

By /s/ WILLIAM A. HOLOHAN,

Assistant U. S. Attorney.

Affidavit of service by mail attached.

[Endorsed]: Filed December 17, 1954.

[Title of District Court and Cause.]

MINUTE ENTRY OF MONDAY

OCTOBER 10, 1955

Honorable Dave W. Ling, United States District Judge, Presiding.

Government's Motion to Dismiss comes on regularly for hearing this day. No appearance is made for the plaintiff. Everett Gordon, Esq., Assistant United States Attorney, is present for the defendant. Said motion is now argued.

It Is Ordered that Government's Motion to Dismiss is granted and that plaintiff is allowed 20 days to file amended complaint.

[Title of District Court and Cause.]

AMENDED COMPLAINT

Comes Now M. H. Sherman Company, a corporation, plaintiff, and for its Amended Complaint against the defendant, The United States of America, complains and alleges:

I.

That the plaintiff is now and at all times herein mentioned has been a corporation, organized and existing under and by virtue of the laws of the State of California, and duly qualified to do business in the State of Arizona.

That defendant is now and at all times herein mentioned has been a body politic, corporate and sovereign.

II.

That this action and the tort claim for which the plaintiff sues arises under Title 28, United States Code, Section 1346(b), as hereinafter more fully appears.

III.

That the plaintiff is now and at all times herein mentioned has been the owner in fee of the following described real property situated in the County of Maricopa, State of Arizona, to wit:

That part of the West Half ($W\frac{1}{2}$) Section Thirty-four (34), Township Two North (T2N), Range Four East (R4E), Gila and Salt River Base and Meridian, lying West of the crosscut canal Except a parcel approximately 150 feet by 150 feet in the Northwest corner thereof, Maricopa County, Arizona, containing approximately 175 acres.

IV.

That on or about the 16th day of May, 1943, said plaintiff and said defendant entered into a written lease dated the 16th day of May, 1943, whereby the said plaintiff, as lessor, leased to the said defendant, as lessee, to be used by the lessee for the requirements of the War Department, said real property above described for the period beginning with the 16th day of May, 1943, and ending with the 30th day of June, 1943, with the provision that said lease at

the option of the Lessee be renewed from year to year and, by supplemental written agreement dated June 23, 1943, made between said lessor and said lessee, the term of said lease was extended for the period beginning July 1, 1943, through June 30, 1944, with the provision that unless and until lessee should give to lessor thirty (30) days advance written notice of cancellation of said lease, the said lease should remain in force thereafter from year to year without further notice and with the further provision that said lease should in no event extend beyond six months from the date of the termination of the unlimited national emergency as was declared by the President of the United States on May 27, 1941 (Proclamation 2487), and that the term of said lease expired on October 27, 1952, as a result of Presidential Proclamation No. 2974 of April 28, 1952, terminating such unlimited national emergency, and the expiration of six months thereafter.

V.

That upon the execution of said lease, the defendant entered into the possession and occupancy of said premises and established thereon a military camp for the quartering of soldiers and for other military activities, and erected thereon many wooden barracks, bath houses, latrines, and other accessories and other appurtenant buildings, with concrete foundations, floors, slabs, platforms and other appurtenances, and other concrete structures, or parts of structures, and underground pipes, a concrete swimming pool and a tennis court with a hard sur-

face pavement, and the defendant acting by and through its officers and employees within the scope of their employment at the termination of said lease wrongfully and tortiously failed and refused, and still fails and refuses, although demand has been made upon it so to do, to remove from said premises the concrete of the said floors, foundations, slabs, platforms, swimming pool, and other structures and appurtenances and the said pipes and the pavement of said tennis court, and has thereby committed waste on said premises to the great injury and damage of the said premises and of plaintiff's reversionary interest, estate and inheritance in said premises and to the injury and damage of the plaintiff in the sum of Forty Thousand Dollars (\$40,000.00), which is the reasonable cost of the excavation and removal from said premises of all thereof.

Wherefore, Plaintiff prays for judgment against said defendant as follows:

1. For the said sum of Forty Thousand Dollars (\$40,000.00).
2. For plaintiff's costs and disbursements herein.
3. For such other and further relief as to the Court shall seem proper.

GUST, ROSENFELD,
DIVELBESS & ROBINETTE,

By /s/ IVAN ROBINETTE,
Attorneys for Plaintiff.

Receipt of copy acknowledged.

[Endorsed]: Filed October 27, 1955.

[Title of District Court and Cause.]

MOTION TO DISMISS
AMENDED COMPLAINT

Now Comes the United States of America by Jack D. H. Hays, United States Attorney for the District of Arizona, and Everett L. Gordon, Assistant United States Attorney for said District, and moves, pursuant to Rule 12(b) of the Federal Rules of Civil Procedure, that the Court dismiss the Amended Complaint for:

(1) Lack of jurisdiction on the subject matter.

(2) Failure to state a claim upon which relief can be granted.

The grounds for the motion are:

(a) The Court lacks jurisdiction under the Federal Tort Claims Act; and

(b) Plaintiff's real cause of action is based on a written lease and does not sound in tort.

A. photostatic copy of said lease identified as Exhibit A is attached hereto; and Ex. B—copy of letter from Atty. Gen. to the Sec. of the Army, dated Aug. 25, 1954.

JACK D. H. HAYS,
United States Attorney;

/s/ EVERETT L. GORDON,
Assistant U. S. Attorney.

EXHIBIT A

[Exhibit A, Lease, attached to the foregoing is identical to Lease set forth in Plaintiff's Exhibit No. 1 admitted in evidence.]

EXHIBIT B

United States of America
Department of the Army

Washington, 10 January, 1956

I Hereby Certify that the attached letter dated 25 August, 1954, from the Attorney General of the United States to the Secretary of the Army, which pertains to the litigation action entitled M. H. Sherman Company v. The United States of America, Civil No. 2078, United States District Court, District of Arizona, Phoenix Division, is a true copy of a letter on file in the Corps of Engineers. Copies of the stipulations and judgments, together with the evidence of title, inclosed with the original letter are not included.

/s/ W. W. RAGLAND,
Colonel, Corps of Engineers, Assistant Chief of Engineers for Real Estate.

I Hereby Certify that W. W. Ragland, Colonel, Corps of Engineers, who signed the foregoing certifi-

cate, is the Assistant Chief of Engineers for Real Estate, and that to his certification as such full faith and credit are and ought to be given.

In Testimony Whereof I, Wilber M. Brucker, Secretary of the Army, have hereunto caused the seal of the Department of the Army to be affixed and my name to be subscribed by the Deputy Administrative Assistant of the said Department, at the City of Washington, this 16th day of January, 1956.

[Seal] /s/ WILBER M. BRUCKER,
Secretary of the Army.

By /s/ JAMES C. COON,
Deputy Administrative Asst.

Office of the Attorney General
Washington, D. C.

[Department of Justice Seal]

August 25, 1954.

Honorable Robert T. Stevens,
Secretary of the Army,
Washington 25, D. C.

My dear Mr. Secretary:

I have examined the evidence of title and transcript of record in the condemnation proceeding entitled United States of America v. 132.44 acres of land in Maricopa County, Arizona, et al., Civil No.

1855 Phoenix in the United States District Court for the District of Arizona, pertaining to the acquisition of Tract No. 2 for use in connection with the Papago Park Site.

The land is more fully described in the complaint.

The certificate of title was prepared by Dean Edgerton, attorney of the Department of the Army, and is satisfactory in form.

By judgment dated December 3, 1953, just compensation for the use of Tract No. 2 for the period beginning October 28, 1952, and ending June 30, 1953, was determined to be the sum of \$3,221.75, and by judgment dated July 14, 1954, just compensation for the annual use of the tract was determined to be the sum of \$4,800.00. The term taken has been extended to June 30, 1955, but compensation for the use of Tract No. 2 has only been deposited for the period ending June 30, 1954. Accordingly, the compensation for the annual use ending June 30, 1955, should be deposited.

The condemnation proceeding has been regularly conducted, the judgment is satisfied for the period ending June 30, 1954, and a term for years beginning October 28, 1952, and ending June 30, 1954, is vested in the United States of America, extendible for yearly periods thereafter until June 30, 1957, at the election of the Secretary of the Army, subject to existing easements for public roads and highways, for public utilities, for railroads and for pipe lines.

Enclosed are certified copies of the stipulations and judgments, together with the evidence of title.

Sincerely yours,

/s/ HERBERT BROWNELL, JR.,
Attorney General.

Affidavit of service by mail attached.

[Endorsed]: Filed January 18, 1956.

[Title of District Court and Cause.]

MINUTE ENTRY OF FRIDAY, APRIL 13, 1956

Honorable Dave W. Ling, United States District
Judge Presiding.

It Is Ordered that Defendant's Motion to Dismiss
the Amended Complaint is denied.

[Title of District Court and Cause.]

ANSWER TO AMENDED COMPLAINT

United States of America by the United States
Attorney for the District of Arizona in answer to the
Amended Complaint filed herein, alleges as follows:

I.

Defendant admits the allegations in Paragraphs
I, III, IV of the Amended Complaint.

II.

Defendant denies the allegations in Paragraph II of the Amended Complaint.

III.

Defendant denies each and every allegation in Paragraph V of the Amended Complaint, except defendant admits that it entered into possession of the premises under a lease and erected structures and buildings thereon.

First Affirmative Defense

The Amended Complaint fails to state a claim against the defendant upon which relief can be granted.

Second Affirmative Defense

The Court does not have jurisdiction over the subject matter of this action nor of the defendant.

Third Affirmative Defense

The right of action set forth in the Amended Complaint did not accrue within two years preceding the commencement of this action.

Fourth Affirmative Defense

That pursuant to the lease entered into between plaintiff and defendant, and made reference to in Paragraph IV of the Amended Complaint, plaintiff as lessor relieved the defendant as lessee of any and all restoration responsibility resulting from the use of the leased premises.

Fifth Affirmative Defense

That 114 acres of the 175 acres leased to defendant are presently the subject of a condemned use to the defendant for a term of years, said term beginning October 28, 1952, and said proceedings identified as United States of America vs. 132.44 acres of land in the County of Maricopa, State of Arizona; State of Arizona, et al., No. Civ. 1855-Phx.; that defendant is still in possession of said land and entitled to right to possession until June 30, 1957, and restoration costs to the aforesaid 114 acres now held by defendant are and should be part of the condemnation proceedings in No. Civ. 1855-Phx., more fully described above.

Wherefore, defendant prays that plaintiff take nothing by its action and that defendant have judgment and its costs, and such other relief as may seem meet and proper.

JACK D. H. HAYS,
United States Attorney
for the District of Arizona;

/s/ WILLIAM A. HOLOHAN,
Assistant U. S. Attorney.

Affidavit of service by mail attached.

[Endorsed]: Filed April 23, 1956.

[Title of District Court and Cause.]

MINUTE ENTRY OF THURSDAY,
OCTOBER 24, 1957

Honorable Dave W. Ling, United States District
Judge Presiding.

This case having been submitted and by the Court
taken under advisement,

It Is Ordered that judgment will be entered for
the defendant and against plaintiff. upon findings to
be submitted under the rules.

[Title of District Court and Cause.]

No. Civil 2078-Phx.

PLAINTIFF'S REQUESTED FINDINGS OF
FACT AND CONCLUSIONS OF LAW

Comes Now the plaintiff and requests the court, in
addition to the proposed Findings of Fact Nos. 1 and
2, to make the following Findings of Fact and Con-
clusions of Law:

Findings of Fact

1. That the defendant entered into possession of
the premises under the terms of the lease and erected
structures and buildings upon said premises includ-
ing concrete platforms, footings, swimming pool and
tennis court.

2. That the lease expired on October 27, 1952, and defendant did not remove the structures or concrete platforms, footings, swimming pool or tennis court the defendant had constructed on said premises.

3. That the lease between plaintiff and defendant contained the following provision:

“Para. 12. A joint survey and report of the conditions of the within-described premises has been made and has revealed the property to be unimproved desert land, on which there is no physical improvements, and the lessor agrees to the foregoing statement and hereby relieves the Government of any and all restoration responsibility resulting from the use of such land by the Armed Forces.”

4. That the cost of removing the concrete platforms, footings, swimming pool and tennis court is \$17,500.00 and that by reason of the presence of said platforms, footings, swimming pool and tennis court on said premises said premises have diminished in value in the sum of \$17,500.00 and that by reason of the negligence and tortious acts of defendant in failing to remove said platforms, footings, swimming pool and tennis court that plaintiff has been damaged thereby in the sum of \$17,500.00.

Conclusions of Law

1. The court has jurisdiction of the parties and the subject matter.

2. That under the terms of the lease the defendant is liable to plaintiff for damages to the premises caused by defendant's negligence or tortious acts.

3. That the defendant is liable for the damages to the premises caused by its failure to remove the platforms, footings, swimming pool and tennis court.

4. Plaintiff is entitled to judgment against the defendant in the sum of \$17,500.00 and its costs and disbursements.

Dated this 2nd day of November, 1957.

Respectfully submitted,

GUST, ROSENFELD,
DIVELEBESS & ROBINETTE,

By /s/ FRANK E. FLYNN,
Attorneys for Plaintiff.

Receipt of copy acknowledged.

[Endorsed]: Filed November 4, 1957.

[Title of District Court and Cause.]

MINUTE ENTRY OF THURSDAY

December 12, 1957

Honorable Dave W. Ling, United States District
Judge, Presiding.

Plaintiff's objections to defendant's Proposed
Findings of Fact and Conclusions of Law having

been submitted and taken under advisement, the Court now orders as follows:

Plaintiff's objection to defendant's proposed finding of fact Number 4 is allowed.

Plaintiff's objection to proposed finding of fact Number 7 is allowed; the finding should recite that the original complaint was dismissed because it did not contain a short and plain statement of the grounds upon which the court's jurisdiction depended, as required by Rule 8(a).

The remaining objections are overruled.

[Title of District Court and Cause.]

FINDINGS OF FACT AND CONCLUSIONS OF LAW

The above-entitled action having been tried before the Court sitting without a jury and having been submitted to the Court for its decision, and after due consideration the Court makes the following Findings of Fact and Conclusions of Law:

Findings of Fact

1. The Plaintiff is a California corporation qualified to do business in the State and District of Arizona, and the Defendant is the sovereign, United States of America.

2. On May 16, 1943, Plaintiff and Defendant entered into a written lease whereby Plaintiff leased to Defendant certain premises owned by Plaintiff and described as :

That part of the West Half ($W1\frac{1}{2}$), Section Thirty-Four (34), Township Two North (T2N), Range Four East (R4E), Gila and Salt River Base and Meridian, lying West of the cross cut canal Except a parcel approximately 150 feet by 150 feet in the Northwest corner thereof, Maricopa County, Arizona, containing approximately 175 acres.

3. Defendant entered into possession of the premises under the terms of the lease, and, as permitted by the lease, Defendant erected buildings and structures.

4. That the lease between Plaintiff and Defendant contained the following provision :

“Para. 12. A joint survey and report of the conditions of the within-described premises has been made and has revealed the property to be unimproved desert land, on which there is no physical improvements, and the lessor agrees to the foregoing statement and hereby relieves the Government of any and all restoration responsibility resulting from the use of such land by the Armed Forces.”

5. The lease expired on October 27, 1952, and the Defendant did not remove the structures and build-

ings placed on the premises by the Defendant during the term of the lease.

6. Plaintiff filed a complaint with this Court on October 5, 1954, claiming damage in the sum of \$40,000, for waste caused by the Defendant's action in failing to remove structures and buildings from the leased premises heretofore described.

7. The complaint was dismissed by the Court because it did not contain a short and plain statement of the grounds upon which the Court's jurisdiction depended, as required by Rule 8(a) Federal Rules of Civil Procedure, but leave to amend was granted, and on October 27, 1955, Plaintiff filed an amended complaint alleging jurisdiction in this Court under Title 28, United States Code, Section 1346(b), and further alleging that the action of the Defendant in failing to remove structures and buildings at the end of the lease from the above-described premises was wrongful and tortious.

Conclusions of Law

1. The lease specifically relieved the Defendant of any duty to remove buildings or structures from the above-described premises.

2. The Court has jurisdiction of the subject matter and the parties.

3. The Plaintiff will take nothing by its amended complaint, and Defendant is entitled to judgment against Plaintiff for its costs and disbursements incurred herein.

Let judgment enter accordingly.

Dated: Dec. 31, 1957.

/s/ DAVE W. LING,
Judge United States District Court for the District
of Arizona.

Lodged December 19, 1957.

[Endorsed]: Filed December 31, 1957.

In the United States District Court
for the District of Arizona

No. Civil 2078—Phx.

M. H. SHERMAN COMPANY, a Corporation,
Plaintiff,
vs.

UNITED STATES OF AMERICA, a Body Politic,
Corporate and Sovereign,
Defendant.

JUDGMENT

The above-captioned matter having been tried by the Court, and Findings of Fact and Conclusions of Law having been made and filed, now therefore, it is

Ordered, Adjudged and Decreed that plaintiff take nothing by its action, and defendant have judg-

ment against plaintiff for its costs reasonably incurred by this action.

Dated December 31, 1957.

/s/ DAVE W. LING,
Judge United States District Court for the District
of Arizona.

Lodged October 31, 1957.

[Endorsed]: Filed December 31, 1957.

[Title of District Court and Cause.]

NOTICE OF APPEAL

Notice Is Hereby Given that M. H. Sherman Company, a corporation, plaintiff above named, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the final Judgment entered in this action on December 31, 1957.

Dated this 6th day of January, 1958.

GUST, ROSENFELD,
DIVELBESS & ROBINETTE,

By /s/ FRANK E. FLYNN,
Attorneys for Plaintiff-
Appellant.

Receipt of copy acknowledged.

[Endorsed]: Filed January 6, 1958.

[Title of District Court and Cause.]

BOND FOR COSTS

Know All Men by These Presents :

That we, M. H. Sherman Company, a corporation, as Principal, and Fidelity and Deposit Company of Maryland, as Surety, do hereby acknowledge ourselves jointly and severally bound to pay to the United States of America, Defendants, for all costs in the above-entitled suit not to exceed, however, the sum of Two Hundred Fifty (\$250.00) Dollars.

The condition of this Bond is that whereas the Plaintiff corporation has appealed to the Court of Appeals for the Ninth Circuit from the final Judgment entered by this court on December 31, 1957, if said Plaintiff and Appellant shall pay all costs adjudged against it if the appeal is dismissed, or if the Judgment of this court is upheld, then this Bond is to be void; but if the above-named Plaintiff and Appellant shall fail to perform this condition, payment of the amount of this bond shall be due forthwith.

Dated this 6th day of January, 1958.

M. H. SHERMAN COMPANY,
A Corporation,

By /s/ FRANK E. FLYNN,
One of Their Attorneys.

[Seal]

FIDELITY AND DEPOSIT
COMPANY OF MARYLAND,By /s/ C. A. DRUMMOND,
Attorney-in-Fact.

[Endorsed]: Filed January 6, 1958.

In the United States District Court
for the District of Arizona

No. Civ. 2078—Phx.

M. H. SHERMAN COMPANY, a Corporation,
Plaintiff,

vs.

UNITED STATES OF AMERICA, a Body Poli-
tic, Corporate and Sovereign,
Defendant.

TRANSCRIPT OF PROCEEDINGS

Tuesday, September 10, 1957, 10 A.M.

Before: Honorable Dave W. Ling, Judge.

Appearances:

GUST, ROSENFELD, DIVELBESS
& ROBINETTE, ByFRANK E. FLYNN,
Appeared for the Plaintiff.

JACK D. H. HAYS,

United States Attorney, By

WILLIAM A. HOLOHAN,

Appeared for the Defendant.

PROCEEDINGS

The Clerk: Civil No. 2078 Phoenix. M. H. Sherman Company, a Corporation, versus United States of America, Defendant, for trial.

The Court: Are you ready, gentlemen?

Mr. Flynn: Plaintiff is ready.

Mr. Holohan: Defendant is ready.

The Court: You may proceed.

Mr. Flynn: If the Court please, we had some motions in this case some time ago which were argued and decided by the Court. I don't know whether the Court remembers the facts.

The Court: I might recall them if you mentioned them.

Mr. Flynn: This is a suit by the M. H. Sherman Company against the United States.

They entered into a lease, a copy of which will be introduced in evidence. This land out here upon which the Prison Camp was built had a rental of I think around eighty or eighty-five dollars a year.

They constructed these prison buildings out there, with the concrete slabs, swimming pool, tennis court, and so forth, and at the termination of the lease they removed some of the buildings, but they didn't remove the concrete work.

The Court: Yes, I remember that.

Mr. Flynn: And we brought this action for damages as [2*] a result of those slabs being on there.

We have entered into a stipulation with the United States Attorney's office, which has attached to it the certified copy of the lease, and which I think covers all the facts which the plaintiff would be required to prove.

Does the Court want me to read it to him?

The Court: No.

Mr. Flynn: We offer this in evidence.

The Court: All right. It may be received. That is a stipulation, you say?

Mr. Flynn: It is a stipulation, yes.

The Court: All right, it may be received.

The Clerk: Plaintiff's Exhibit 1 in evidence.

(Said Stipulation with Certified Copy of Lease attached was received in evidence and marked as Plaintiff's Exhibit No. 1.)

*Page numbering appearing at top of page of original Reporter's Transcript of Record.

PLAINTIFF'S EXHIBIT No. 1

In the United States District Court
for the District of Arizona

No. Civ. 2078—Phx.

M. H. SHERMAN COMPANY, a Corporation,
Plaintiff,

vs.

UNITED STATES OF AMERICA, a Body Poli-
tic, Corporate and Sovereign,
Defendant.

STIPULATION

It is hereby stipulated by and between the parties hereto that the defendant admits the allegations contained in Paragraphs I, III and IV of the Amended Complaint.

It is further stipulated that the attached certified copy of the lease between the parties may be admitted in evidence without any further identification or proof.

It is further stipulated defendant entered into possession of the premises under the terms of said lease and erected structures and buildings upon said premises including concrete platforms, footings, swimming pool and tennis court, and that at the termination of the lease the defendant did not remove said structures or concrete platforms, footings, swimming pool and tennis court.

Plaintiff's Exhibit No. 1—(Continued)

It is further stipulated that the diminution in value of the said premises by the reason of the presence of said concrete platforms, footings, swimming pool and tennis court is the cost of the removal thereof which it is agreed is the sum of Seventeen Thousand Five Hundred Dollars (\$17,500.00).

It is understood that the defendant does not by this Stipulation admit any liability but that such question shall be determined by the court upon the pleadings and evidence including this Stipulation.

Dated this 10th day of September, 1957.

GUST, ROSENFELD,
DIVELBESS & ROBINETTE,

By /s/ FRANK E. FLYNN,
Attorneys for Plaintiff.

UNITED STATES ATTORNEY,

By /s/ WILLIAM A. HOLOHAN,
Assistant United States
Attorney.

United States of America
Department of the Army

Washington, 5 September, 1957

I Hereby Certify that the attached documents pertaining to the action entitled: M. H. Sherman

Plaintiff's Exhibit No. 1—(Continued)

Company vs. The United States of America, Civil No. 2078, in the United States District Court for the District of Arizona, Phoenix Division, are true copies of papers on file in the Corps of Engineers.

/s/ J. U. MOORHEAD,

Colonel, Corps of Engineers, Assistant Chief of Engineers for Real Estate.

I Hereby Certify that J. U. Moorhead, Colonel, Corps of Engineers, who signed the foregoing certificate, is the Assistant Chief of Engineers for Real Estate, and that to his certification as such full faith and credit are and ought to be given.

In Testimony Whereof I, Wilbur M. Brucker, Secretary of the Army, have hereunto caused the seal of the Department of the Army to be affixed and may name to be subscribed by the Deputy Administrative Assistant of the said Department, at the City of Washington, this 6th day of September, 1957.

[Seal] /s/ WILBUR M. BRUCKER,
Secretary of the Army.

By /s/ JAMES C. COOK,
Deputy Administrative
Assistant.

Plaintiff's Exhibit No. 1—(Continued)

Lease Between
M. H. Sherman Company
and
The United States of America

[Handwritten]: W2972 Eng. 821.

1. This Lease, made and entered into this Sixteenth (16th) day of May, in the year one thousand nine hundred and forty-three, by and between M. H. Sherman Company, a California Corporation whose address is 3670 Wilshire Blvd., Los Angeles, California, for itself, its successors, and assigns, hereinafter called the Lessor, and The United States of America, hereinafter called the Government:

Witnesseth: The parties hereto for the considerations hereinafter mentioned covenant and agree as follows:

2. The Lessor hereby leases to the Government the following described premises, viz.:

That part of the West Half (W $\frac{1}{2}$) Section Thirty-four (34), Township Two North (T2N), Range Four East (R4E), Gila and Salt River Base and Meridian, lying West of the cross cut canal Except a parcel approximately 150 feet by 150 feet in the Northwest corner thereof, Maricopa County, Arizona, containing approximately 175 acres of unimproved desert land.

The supplies and services to be obtained by this instrument are authorized by, are for the

Plaintiff's Exhibit No. 1—(Continued)
purpose set forth in, and are chargeable to
procurement authority.

Eng. 30068 P332-05 A0905-23

The available balance of which is sufficient to cover
cost of same.

to be used exclusively for the following purposes
(see instruction No. 3):

Requirements of the War Department.

3. To Have and to Hold the said premises with
their appurtenances for the term beginning May 16,
1943, and ending with June 30, 1943.

4. The Government shall not assign this lease
in any event, and shall not sublet the demised prem-
ises except to a desirable tenant, and for a similar
purpose, and will not permit the use of said prem-
ises by anyone other than the Government, such
sublessee, and the agents and servants of the Gov-
ernment, or of such sublessee.

5. This lease may, at the option of the Govern-
ment, be renewed from year to year at a rental of
Eighty-five and no/100 (\$85.00) Dollars, or pro
rata amount for fractional period of use thereof and
otherwise upon the terms and conditions herein
specified, provided notice be given in writing to the
Lessor at least Fifteen (15) days before this lease
or any renewal thereof would otherwise expire:
Provided that no renewal thereof shall extend the
period of occupancy of the premises beyond six

Plaintiff's Exhibit No. 1—(Continued)

months from the date of the termination of the unlimited National Emergency declared by the President of the United States on May 27, 1941. (Proclamation 2487.)

6. The Lessor shall furnish to the Government, during the occupancy of said premises, under the terms of this lease, as part of the rental consideration, the following:

Nothing.

7. The Government shall pay the Lessor for the premises rent at the following rate:

Eighty-Five and no/100 (\$85.00) Dollars per annum, or pro rata amount for a fractional period of use thereof. Finance Officer, U. S. Army, Fort Douglas, Utah, is designated to pay this account.

Payment shall be made at the end of each fiscal year.

8. The Government shall have the right, during the existence of this lease, to make alterations, attach fixtures, and erect additions, structures, or signs, in or upon the premises hereby leased (provided such alterations, additions, structures, or signs shall not be detrimental to or inconsistent with the rights granted to other tenants on the property or in the building in which said premises are located); which fixtures, additions, or structures so placed in or upon or attached to the said premises

Plaintiff's Exhibit No. 1—(Continued)

shall be and remain the property of the Government and may be removed therefrom by the Government prior to the termination of this lease, ~~and the Government~~, if required by the Lessor, shall before the expiration of this lease or renewal thereof, restore the premises to the same conditions ~~as~~ that existing at the time of entering upon the same under this lease, reasonable and ordinary wear and tear and damages by the elements ~~or by circumstances~~ over which the Government has no control, excepted. Provided, however, that if the Lessor requires such restoration, the Lessor shall give written notice thereof to the Government days before the termination of the lease.

9. The Lessor shall, unless herein specified to the contrary, maintain the said premises in good repair and tenantable condition during the continuance of this lease, except in case of damage arising from the act or the negligence of the Government's agents or employees. For the purpose of so maintaining the premises, the Lessor reserves the right at reasonable times to enter and inspect the premises and to make any necessary repairs thereto.

10. If the said premises be destroyed by fire or other casualty this lease shall immediately terminate. In case of partial destruction or damage, so as to render the premises untenable, either party may terminate the lease by giving written notice to the other within fifteen days thereafter,

Plaintiff's Exhibit No. 1—(Continued)

~~[Indistinguishable] no rent shall accrue to the Lessor after such partial destruction or damage.~~

11. No Member of or Delegate to Congress or Resident Commissioner shall be admitted to any share or part of this lease or to any benefit to arise therefrom. Nothing, however, herein contained shall be construed to extend to any incorporated company, if the lease be for the general benefit of such corporation or company.

12. A joint survey and inspection of the conditions of the within-described premises has been made and reveals the property to be unimproved desert land, on which there are no physical improvements, and the lessor agrees to the foregoing statement and hereby relieves the Government of any and all restoration responsibility resulting from the use of the subject lands by the Armed Forces.

13. The Government reserves the right to cancel this lease or any renewal thereof by giving thirty (30) days' advance written notice to the Lessor.

Paragraph 8, beginning on line 7 with the words "and the Government" and continuing to end of said paragraph, deleted; paragraphs 9 and 10 deleted; paragraphs 12 and 13 are added, and made a part hereof, prior to execution.)

Map marked Exhibit "A" attached hereto and made a part hereof.

Plaintiff's Exhibit No. 1—(Continued)

In Witness Whereof, the parties hereto have hereunto subscribed their names as of the date first above written.

[Seal] M. H. SHERMAN COMPANY,

By /s/ ARNOLD D. HASKELL,
President, Lessor.

/s/ J. H. RISHEBERGER,
Secretary.

UNITED STATES OF
AMERICA,

By /s/ FRANCIS M. WILKINSON,
Contracting Officer.

In presence of:

/s/ ETHEL L. REDFIELD,
2325 Ocean View Ave.,
Los Angeles, Calif.

(If Lessor is a corporation, the following certificate shall be executed by the secretary or assistant secretary.)

I, J. J. Walsh, certify that I am the Assistant Secretary of the corporation named as Lessor in the attached lease; that Arnold D. Haskell and J. H. Risheberger, who signed said lease on behalf of the Lessor, was then President and Secretary, respectively, of said corporation; that said lease was duly signed for and in behalf of said corporation by

Plaintiff's Exhibit No. 1—(Continued)
authority of its governing body, and is within the
scope of its corporate powers.

[Seal] /s/ J. J. WALSH.

[Stamped]: Division Engineer.
Negotiated Contract.
[Initialed]: J.M.W.

Instructions to Be Observed in Executing Lease

1. This standard form of lease shall be used whenever the Government is the lessee of real property; except that when the total consideration does not exceed \$100 and the term of the lease does not exceed 1 year the use of this form is optional. In all cases where the rental to be paid exceeds \$2,000 per annum the annual rental shall not exceed 15 per centum of the fair market value of the rented premises at the date of lease. Alterations, improvements, and repairs of the rented premises by the Government shall not exceed 25 per centum of the amount of the rent for the first year of the rental term or for the rental term if less than 1 year.

2. The lease shall be dated and the full name and address of the lessor clearly written in paragraph 1.

3. The premises shall be fully described, and, in case of rooms, the floor and room number of each room given. The language inserted at the end of article 2 of the lease should specify only the general

Plaintiff's Exhibit No. 1—(Continued)

nature of the use, that is, "office quarters," "storage space," etc.

4. Whenever the lease is executed by an attorney, agent, or trustee on behalf of the lessor, two authenticated copies of his power of attorney, or other evidence to act on behalf of the lessor, shall accompany the lease.

5. When the lessor is a partnership, the names of the partners composing the firm shall be stated in the body of the lease. The lease shall be signed with the partnership name, followed by the name of the partner signing the same.

6. Where the lessor is a corporation, the lease shall be signed with the corporate name, followed by the signature and title of the officer or other person signing the lease on its behalf, duly attested, and, if requested by the Government, evidence of his authority so to act shall be furnished.

7. Under paragraph 6 of the lease insert necessary facilities to be furnishd, such as heat, light, janitor service, etc.

8. There shall be no deviation from this form without prior authorization by the Director of Procurement, except—

(a) Paragraph 3 may be drafted to cover a monthly tenancy or other period less than a year.

Plaintiff's Exhibit No. 1—(Continued)

(b) In paragraph 5, if a renewal for a specified period other than a year, or for a period optional with the Government is desired, the phrase "from year to year" shall be deleted and proper substitution made. If the right of renewal is not desired or cannot be secured paragraph 5 may be deleted.

(c) Paragraph 6 may be deleted if the owner is not to furnish additional facilities.

(d) If the premises are suitable without alterations, etc., paragraph 8 may be deleted.

(e) Paragraph 9 provides that the lessor shall, "unless herein specified to the contrary, maintain the said premises in good repair, etc." A modification or elimination of this requirement would not therefore be a deviation.

(f) In case the premises consist of unimproved land, paragraph 10 may be deleted.

(g) When executing leases covering premises in foreign countries, departure from the standard form is permissible to the extent necessary to conform to local laws, customs, or practices.

(h) Additional provisions, relating to the particular subject matter mutually agreed upon, may be inserted, if not in conflict with the standard provisions, including a mutual

Plaintiff's Exhibit No. 1—(Continued)
right to terminate the lease upon a stated number of days' notice, but to permit only the lessor so to terminate would be a deviation requiring approval as above provided.

9. When deletions or other alterations are permitted specific notation thereof shall be entered in the blank space following paragraph 11 before signing.

10. If the property leased is located in a State requiring the recording of leases in order to protect the tenant's rights, care should be taken to comply with all such statutory requirements.

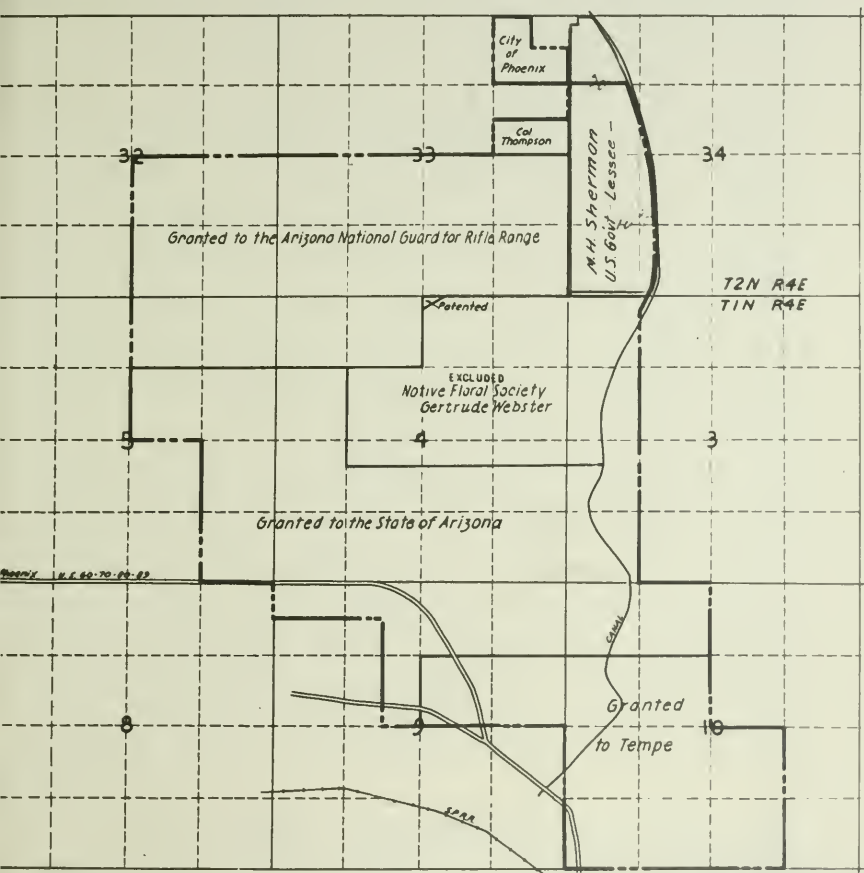
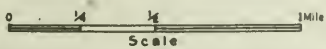


Exhibit "A"



For Base & Meridian

WAR DEPARTMENT
CORPS OF ENGINEERS
SOUTH PACIFIC DIVISION
REAL ESTATE BRANCH
PHOENIX, ARIZONA

PHOENIX CANTONMENT CAMP SITE
PAPAGO PARK
MARICOPA COUNTY, ARIZONA
SEPT. 15, 1942

Plaintiff's Exhibit No. 1—(Continued)

Certified Copy of Resolution

“Resolved, That the President or Vice President, together with the Secretary or Assistant Secretary, be and they hereby are authorized to sign the name of this corporation and to execute for and on behalf of this corporation any and all deeds, mortgages, trust deeds, assignments of Stock Certificates, bonds, bills of exchange, promissory notes, releases of mortgages, assignments of mortgages, requests for reconveyance, contracts for the sale or purchase of real estate or other property, and all other contracts, agreements, leases, indentures and/or evidences of indebtedness that they may deem necessary or proper for the corporation to sign, execute and deliver. The President or Vice President shall have the power to confer the authority hereby given to him on other officers and agents of the corporation as may in his judgment be necessary to facilitate its business. When such authority is conferred on any person by the President, a record thereof shall be made in the Minute Book of the Board of Directors.”

I hereby certify the foregoing to be a true and correct copy of a resolution passed by the Board of Directors of M. H. Sherman Company, at a regular meeting of said Board held on the 22nd day of May, 1935, at the office of the corporation in Los Angeles, California, at which meeting a majority was present and unanimously adopted said resolu-

Plaintiff's Exhibit No. 1—(Continued)

tion. Said resolution is now, and ever since the 22nd day of May, 1935, has been in full force and effect.

I further certify that Arnold D. Haskell is the President and J. H. Risheberger is the Secretary of M. H. Sherman Company.

Date: May 16, 1943.

[Seal] /s/ J. J. WALSH,

Assistant Secretary of
M. H. Sherman Company.

Record Physical Survey of Land and/or Buildings

AR 30-1415

Papago Park, Phoenix, Maricopa Co., Arizona

May 16, 1943

This record to be appended to and made a part of an agreement entered into between the United States of America and the undersigned; owner of the property hereinafter identified.

1. Identity of Property:

That part of the West Half ($W\frac{1}{2}$) Section Thirty-four (34), T2N, R4E, G.&S.R.B.&M, lying West of the cross-cut canal Except a parcel approximately 150' x 150' in the NW corner thereof, Maricopa County, Arizona.

Plaintiff's Exhibit No. 1—(Continued)

2.

Land approx. 17 acres. Total approx. 175 acres

3. Type Building:

Unimproved Desert Land.

4. Fencing:

Amount: Approx. 200'.

Type: Old page fence wire and posts, posts very bad condition.

* * *

7. Remarks:

The land is fairly level.

/s/ PAUL W. TAYLOR,
Officer of Using Agency.

PAUL W. TAYLOR, Major,
Corps of Engineers, Vicinity
Maintenance Engr.

M. H. SHERMAN COMPANY,

/s/ ARNOLD D. HASKELL
Owner or Agent.

/s/ J. H. RISHEBERGER,
5670 Wilshire Blvd.,
Los Angeles, California.

Plaintiff's Exhibit No. 1—(Continued)

Supplemental Agreement to Dispense With
Notice of Renewal

This Supplemental Agreement entered into this twenty-third day of June, 1943, by and between M. H. Sherman Company, a California Corporation, whose address is 3670 Wilshire Blvd., Los Angeles, California, for itself, its successors, and assigns, hereinafter called the Lessor, and the United States of America, hereinafter called the Government,

Witnesseth:

Whereas on May 16, 1943, a lease was entered into between the Lessor and the Government covering

That part of the West Half (W1½) Section Thirty-four (34), Township Two North (T2N), Range Four East (R4E), Gila and Salt River Base and Meridian, lying West of the cross-cut canal Except a parcel approximately 150 feet by 150 feet in the Northwest corner thereof, Maricopa County, Arizona, containing approximately 175 acres of unimproved desert land.

for the period May 16, 1943, to June 30, 1943, with option of renewal annually thereafter, said renewal period being for six months from the date of the termination of the unlimited National Emergency.

Whereas it is desired to amend said lease to dispense with the service of notice of renewal for each fiscal year, as hereinafter provided;

Now, Therefore, the parties hereto do hereby amend said lease in the following respects and in these only:

1. Provisions 3 and 5 are deleted, and there is inserted in lieu thereof the following provision numbered 3, effective July 1, 1943:

“3. To Have and to Hold the said premises with their appurtenances for the term beginning July 1, 1943, through June 30, 1944, provided that, unless and until the Government shall give notice of termination in accordance with provision 13 hereof, this lease shall remain in force thereafter from year to year without further notice; provided further that adequate appropriations are available from year to year for the payment of rentals; and provided further that this lease shall in no event extend beyond six months from the date of the termination of the unlimited National Emergency as declared by the President of the United States on May 27, 1941. (Proclamation 2487.)

In Witness Whereof, the parties hereto have hereunto subscribed their names as of the date first above written.

[Seal] M. H. SHERMAN COMPANY,

By /s/ ARNOLD D. HASKELL,
President.

/s/ J. H. RISHEBERGER,
Secretary.

Plaintiff's Exhibit No. 1—(Continued)

THE UNITED STATES OF
AMERICA,By /s/ FRANCIS M. WILKINSON,
Contracting Officer.

In presence of:

/s/ ETHEL L. REDFIELD,
Witness, 2325 Ocean View
Ave., Los Angeles, Calif.

(If Lessor is a corporation, the following certificate shall be executed by the Secretary or Assistant Secretary.)

I, J. J. Walsh, certify that I am the Assistant Secretary of the corporation named as Lessor in the attached lease; that Arnold D. Haskell & J. H. Risheberger, who signed said lease on behalf of the Lessor, was then President and Secretary, respectively, of said corporation; that said lease was duly signed for and in behalf of said corporation by authority of its governing body, and is within the scope of its corporate powers.

[Seal] /s/ J. J. WALSH,
92-2655

Admitted in evidence September 10, 1957.

Mr. Flynn: That is our case.

The Court: All right.

Mr. Holohan: The Defendant's case consists of, first of all, the objection to jurisdiction of this Court.

At this time we would like to renew our motion to dismiss the case, based on the jurisdiction, and, further, move for judgment.

The plaintiffs brought their action, first of all, sounding in contract under the Tucker Act, based on the lease, [3] a suit for some \$40,000.00, which was brought in this court.

This Court had no jurisdiction then. The complaint was dismissed, properly so, so that the plaintiff then could bring his action in the Court of Claims.

But there was an Amended Complaint filed in this action which now sounds in tort, or purportedly sounds in tort. Actually, the action consists of waste, and waste, as we know, is not a tort. So that is the second theory we have, on jurisdiction, that it is not a proper action for the tort claim; and, really, our first is that when the Amended Complaint was filed, the two years within which the action could be brought had expired, therefore, this Court had no jurisdiction.

The third basis which we move for judgment on is that the action, on the present action, that by virtue of the lease, which is part of Exhibit 1, there was no duty upon the defendant to remove anything from the property, that then, pursuant to the lease, that we left what we desired on the property, and plaintiff could do with it as they pleased.

The third theory which we are operating on is that prior to entering into possession of the entire tract, the Government condemned some 114 acres of the land, which has been subsequent to, has been part of a Condemnation Action, and that as to any property in the condemnation, if they had any remedy, it would be possibly for restoration damages. [4]

In order to make that a part of the record of this case, I have secured certified copies of the main documents in that condemnation, which I will present to the Clerk and ask for marking for identification.

May this be marked as Government's Exhibit B for identification.

Mr. Flynn: Why don't you offer the whole file? The Court shouldn't have it piecemeal.

Mr. Holohan: All right. I will take counsel's suggestion, then.

This, then, could be marked as Exhibit "A" for identification, consisting of the Declaration of Taking, Complaint, Order for Delivery of Possession, and Judgment of Declaration of Taking, in a case captioned United States of America, Plaintiff, versus 132 Acres of Land, More or Less, in the County of Maricopa, State of Arizona, Arizona Public Service Company, et al., No. Civil 1855 Phoenix.

And this document, finally as Government's Exhibit "B," which is Civil 2682 Phoenix, United States of America versus 76.23 Acres of Land, More or Less; which is a continuation of the same condemnation under different number.

The Clerk: Government's Exhibits "A" and "B" for identification.

(Said Documents were marked as Government's Exhibits "A" and "B" for identification.) [5]

Mr. Holohan: At this time the Government offers the Government's Exhibits "A" and "B"; Government's Exhibit "A" consisting of all certified documents by the Clerk of this Court; and Government's Exhibit "B" consisting of one certified document by the Clerk of this Court.

Mr. Flynn: We want to interpose an objection as to the materiality, on the ground that they are immaterial, and not tending to prove anything within the issues of this case.

On the further ground that it is not a complete record of the case, but only a part of the record of the condemnation case, and, therefore, doesn't give the complete story to the Court; and I don't think we should be put in the position of having to offer something which we do not consider material.

The Court: All right, it may be received subject to your objection.

The Clerk: Government's Exhibits "A" and "B" in evidence.

(Said Certified Copies of documents in cases numbered Civil 1855 and 2682-Phx. were received in evidence and marked as Government's Exhibits "A" and "B," respectively.)

Mr. Holohan: That consists of our evidence in the case, your Honor.

At this time we renew the motion to dismiss for lack of jurisdiction, and the motion for judgment.

The Court: All right.

Mr. Flynn: As part of the record, of course, we move for judgment in the amount stipulated in the stipulation as the measure of damages, in the event the Court should rule that the defendant is liable.

The Court: All right. All these points were pretty well briefed, weren't they?

Mr. Flynn: Yes, most of them were pretty well briefed.

The Court: Do you want to add anything?

Mr. Holohan: Yes, I would desire to file an additional brief, your Honor.

The Court: All right. How much time do you want?

Mr. Holohan: Twenty days.

The Court: Then you may have twenty days.

Mr. Flynn: Yes. Twenty days.

The Court: And ten days to reply.

Mr. Holohan: All right, your Honor. Thank you.

The Court: The Court will stand at recess.

(Which was all of the proceedings had in the above-entitled matter.) [7]

Certificate

I hereby certify that I am a duly appointed, qualified and acting official court reporter of the United States District Court for the District of Arizona.

I further certify that the foregoing is a true and correct transcript of the proceedings had in the above-entitled cause on the dates specified therein,

and that said transcript is a true and correct transcription of my stenographic notes.

Dated at Phoenix, Arizona, this 8th day of January, A.D. 1956.

/s/ JANE HORSWELL,
Official Reporter.

[Endorsed]: Filed January 8, 1958, [8]

[Title of District Court and Cause.]

CLERK'S CERTIFICATE TO RECORD ON
APPEAL

United States of America,
District of Arizona—ss.

I, William H. Loveless, Clerk of the United States District Court, for the District of Arizona, do hereby certify that I am the custodian of the records of said Court, including the records in the case of M. H. Sherman Company, a corp., Plaintiff, vs. The United States of America, a Body Politic, Corporate and Sovereign, Defendant, numbered Civ-2078 Phoenix, on the docket of said Court.

I further certify that the attached original documents bearing the endorsements of filing thereon are the originals of said documents filed in said case, and that the attached copies of minute entries and civil docket entries are true and correct copies of

the originals thereof remaining in my office in the City of Phoenix, State and District aforesaid.

I further certify that the said documents, together with the original exhibits transmitted herewith, constitute the record on appeal in said case as designated, and the same are as follows, to wit:

1. Complaint.
2. Motion to Dismiss Complaint.
3. Minute entry of October 10, 1955 (order granting Motion to Dismiss Complaint).
4. Amended Complaint.
5. Motion to Dismiss Amended Complaint.
6. Minute entry of April 13, 1956 (Order denying motion to Dismiss Amended Complaint).
7. Answer to Amended Complaint.
8. Minute entry of September 10, 1957 (Proceedings of trial).
9. Minute entry of October 24, 1957 (Order for judgment).
10. Defendant's Proposed Findings of Fact and Conclusions of Law.
11. Plaintiff's Objections to Defendant's Proposed Findings of Fact and Conclusions of Law.
12. Plaintiff's Requested Findings of Fact and Conclusions of Law.

13. Minute entry of December 12, 1957 (Ruling on objections to proposed findings of fact).

14. Findings of Fact and Conclusions of Law.

15. Judgment.

16. Notice of Appeal.

17. Bond for Costs on Appeal.

18. Designation of Contents of Record on Appeal.

19. Counterdesignation of Contents of Record on Appeal.

20. Reporter's Transcript of Proceedings.

21. Civil Docket Entries.

I further certify that the following original exhibits are transmitted herewith as a part of this record on appeal, as designated, to wit:

Plaintiff's exhibit 1, in evidence.

Government's exhibits A and B, in evidence.

Witness my hand and the seal of said Court this 7th day of February, 1958.

[Seal] /s/ WM. H. LOVELESS,

Clerk.

[Endorsed]: No. 15892. United States Court of Appeals for the Ninth Circuit. M. H. Sherman Company, a Corporation, Appellant, vs. United States of America, Appellee. Transcript of Record. Appeal from the United States District Court for the District of Arizona.

Filed: February 10, 1958.

Docketed: February 19, 1958.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

United States Court of Appeals
for the Ninth Circuit

No. 15892

M. H. SHERMAN COMPANY, a Corporation,
Appellant,

vs.

UNITED STATES OF AMERICA,
Appellee.

STATEMENT OF POINTS UPON WHICH
APPELLANT WILL RELY

The Appellant, M. H. Sherman Company, a corporation, will raise and rely upon the following points upon the appeal of this matter:

1. That the provisions of the lease between plaintiff and defendant did not relieve defendant of the duty to remove the concrete structures from the premises at the termination of the lease.

2. That the lease between the plaintiff and defendant gave rise to a duty on the part of defendant to use the property so as not to cause damage or injury to the inheritance.

3. That the failure of defendant to remove the concrete structures at the termination of the lease constituted a tort resulting in damage to the premises.

4. That this action was brought under the tort claims act, Title 28, Sec. 1346(b).

GUST, ROSENFELD, DIVEL-
BESS & ROBINETTE,

By /s/ FRANK E. FLYNN,
Attorneys for Appellant.

Receipt of copy acknowledged.

[Endorsed]: Filed February 19, 1958.

IN THE
United States Court of Appeals
For the Ninth Circuit

M. H. SHERMAN COMPANY, a Corporation,
Appellant

VS.

UNITED STATES OF AMERICA,
Appellee

APPELLANT'S REPLY BRIEF

GUST, ROSENFELD, DIVELBESS & ROBINETTE
328 Security Building, Phoenix, Arizona

By FRANK E. FLYNN
Attorneys for Appellant

FILED

MAY 26 1958

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IN THE
United States Court of Appeals
For the Ninth Circuit

No. 15892

M. H. SHERMAN COMPANY, a Corporation,
Appellant

vs.

UNITED STATES OF AMERICA,
Appellee

APPELLANT'S REPLY BRIEF

The Appellee has stated the two issues that are involved in this appeal. One is a jurisdictional issue and the other is an issue on the merits. We will discuss the jurisdictional issue first.

JURISDICTION

Appellee's argument in support of its position on this question is based primarily on the Statute of Limitations. This statute is invoked on the premise that the original Complaint was an attempt to secure relief under the Tucker Act and the conclusion that the Amended Complaint is barred by the Statute of Limitations because it is based on the Civil Tort Claims Act. The premise is false and the conclusion is a non sequitur.

The Appellee has assumed that the first Complaint states a cause of action under the Tucker Act but was dismissed because the claim was in excess of \$10,000 and beyond the court's jurisdiction. We strongly urge that the Complaint alleges facts constituting a cause of action under the Tort Claims Act but was dismissed because it did not allege jurisdiction under that Act. We also urge that the amendment did not change the cause of action but merely added the allegation showing jurisdiction.

Many times in the Federal Court complaints have failed to properly allege diversity of citizenship. Amendments have been permitted at the time of the trial and even after admittance of all the evidence. We have found no cases in the reports in which the courts have held that such an amendment could not be made after the running of the Statute of Limitations. The District Court of Appeals of California has passed upon an analogous situation,

Hess vs. Moody, 95 P. 2d 699 at page 702 (Headnote 6, 7).

In the present case the pleader could not have intended to bring this action under the Tucker Act or he would not have exceeded the jurisdictional amount. Isn't it more reasonable to conclude that the intention was to bring the action under the Tort Claims Act and by an oversight failed to allege jurisdiction?

The factual situation in both the original and amended Complaints is the same. That should be the principal test. The facts are the same and the evidence to prove the allegations of each Complaint would be identical. Even if we should accept Appellee's theory that the original Complaint was brought under the Tucker Act,

it does not follow that the Amended Complaint would be barred by the Statute of Limitations. The Supreme Court of the United States has passed upon that question.

U. S. vs. Memphis Cotton Oil Company, 288 U. S. 62, 77 Law Ed. 619

We quote from Headnote 2 of the opinion in the above case:

“A change of the legal theory of the action, ‘a departure from law to law,’ has at times been offered as a test. (Citing authorities). Later decisions have made it clear that this test is no longer accepted as one of general validity. (Citing authorities).”

The following authorities also sustain our position:

34 AM. JUR. 217-219, paragraphs 266-267

L. J. Bordeaux vs. Tucson Gas Company, 114 Pac. 547 (Ariz.); 33 L. R. A. New Series 196 (also annotation)

Nesbitt vs. Pollak, 80 A. 2nd 54 at page 56

District of Columbia vs. Leys, 63 Fed. 2d 646

Deloach vs. Griggs, 72 S. E. 2d 647

In the Arizona case above cited the Supreme Court of Arizona has applied the liberal rule in regard to an amended pleading relating back to the original pleading where the Statute of Limitations has intervened. In the case of *Nesbitt vs. Pollak* above cited, the Supreme Court of South Carolina quotes from the federal decision in the *District of Columbia* case above cited:

“Whenever the claim or defense asserted in the amended pleading arose out of the conduct, transac-

tion, or occurrence set forth or attempted to be set forth in the original pleading, the amendment relates back to the date of the original pleading.”

Certainly the claim in each of the Complaints, the original and the amended, arose out of the same transaction and occurrence.

In the *Deloach vs. Griggs* case above cited the Supreme Court of South Carolina quotes from 34 Am. Jur. at page 217, which we have already cited. The quotation is as follows:

“It is also stated in 34 Am. Jur., Sec. 263, Page 217, that ‘* * * there is a large and respectable body of authorities * * to the effect that an amended pleading which supplies a missing allegation without the presence of which in plea and proof there could be no recovery relates back, and is unaffected by the statute of limitations expiring after the suit was begun and before the amendment was made.’ ”

The Supreme Court of South Carolina also refers to a prior decision of that Court to the effect that shifting of the basis of an action from a state to a federal law would work no prejudicial surprise and would not introduce a new cause of action. The South Carolina case was affirmed by the Supreme Court of the United States,

239 U. S. 252; 60 Law Ed. 320.

ARGUMENT ON THE MERITS

The issue on the merits is not, as stated by Appellee, whether the government, under the terms of the lease, was required to remove improvements from Appellant's land. The question in our opinion is whether the Appellee could remove parts of the structures without

removing all. It is admitted in the Stipulation in evidence (R 32) that the damage to the premises by reason of the concrete slabs would be the cost of removal. As stated in our Opening Brief, removal of the super structure left the concrete part useless and worthless and a damage to the premises in the sum of \$17,500.

We will not go into a discussion or analysis of the authorities cited by Appellee on the contractual obligation of a tenant to remove improvements. We do not believe they have any application to the facts in this case.

The only way the contract enters into a determination of the issues is that by reason of the contract a relationship was created between Appellant and Appellee, that of landlord and tenant, and that by reason of that relationship a duty arose created by the contract but not a part of its terms. The authorities cited in our Opening Brief sustain this theory.

As far as we have been able to determine, it has been the contention of the Appellee that paragraph 12 of the contract excuses the government from any liability for the damages caused by the failure to remove the concrete structures. So, it is because of the Appellee's theory that an interpretation of the contract was brought into this case.

We respectfully submit that the option to remove the improvements could not be exercised in part by the tenant to the damage of the premises. If the Appellee had removed the roof from each of the buildings, wouldn't the Court be justified in saying that it must pay for the removal of the remaining part? By removing the buildings Appellee left some useless and valueless concrete slabs and according to the stipulation,

this resulted in damages to the premises in the sum of \$17,500. There is no question as to the amount of damage or the cause of it. The only question is as to the liability of the Appellee.

Appellee claims that the great increase in value brought about by time and circumstances should be taken into consideration for the benefit of the Appellee as an offset to the damage to the property. This is going outside the record for an absurd argument reduced to the ridiculous.

CONCLUSION

Based upon the facts and the authorities cited by Appellant, the trial court had jurisdiction and should have entered judgment for plaintiff (Appellant). The case should be reversed and remanded with directions to enter judgment in the sum of \$17,500.00.

Respectfully submitted,

GUST, ROSENFELD, DIVELBESS & ROBINETTE
328 Security Building, Phoenix, Arizona

By FRANK E. FLYNN
Attorneys for Appellant

No. 15895✓

United States
Court of Appeals
for the Ninth Circuit

ANTUN KARLO KOCELJ,

Appellant,

vs.

BRUCE G. BARBER, District Director, Immigration,
and HERBERT BROWNELL, JR., as
Attorney General of the United States,

Appellee.

Transcript of Record

Appeal from the United States District Court for the
Northern District of California,
Southern Division.

FILED

MAR 31 1958

PAUL P. O'BRIEN, CLERK

No. 15895

United States
Court of Appeals
for the Ninth Circuit

ANTUN KARLO KOCELJ,

Appellant,

vs.

BRUCE G. BARBER, District Director, Immigration, and HERBERT BROWNELL, JR., as Attorney General of the United States,

Appellee.

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF COUNSEL

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Post Office Building,
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JACKSON AND HERTOGS,
JOSEPH S. HERTOGS, ESQ.,
580 Washington Street,
San Francisco, California,
For Appellant.

In the United States District Court in and for the
Northern District of California, Southern Division

No. 35089

ANTUN KARLO KOCELJ,

Plaintiff,

vs.

BRUCE G. BARBER, as District Director, San
Francisco District, Immigration and Naturali-
zation Service, and HERBERT BROWNELL,
JR., as Attorney General of the United States,

Defendants.

PETITION FOR REVIEW

Comes Now the plaintiff, Antun Karlo Kocelj,
complains of the defendants and for cause alleges:

I.

That this complaint is filed and these proceedings
are instituted under Section 10 of the Administra-
tive Procedure Act (60 Stat. 243, 5 U.S.C. 1009)
seeking judicial review of the administrative action
taken in plaintiff's case;

II.

That the plaintiff is an alien, a native of Yugo-
slavia, who last entered the United States at Phila-
delphia, Pennsylvania, on March 8, 1941; that at the
time of his arrival on March 8, 1941, plaintiff was
inspected and admitted to the United States by the
Immigration and Naturalization Service as a sea-

man for a period of sixty (60) days under the provisions of Section 3(5) of the Immigration Act of 1924 (43 Stat. 154; 8 U.S.C. 203), as amended;

III.

That in May, 1941, the plaintiff was arrested by the Immigration and Naturalization Service at El Paso, Texas, as an alien illegally in the United States; that the Immigration and Naturalization Service thereafter ordered the plaintiff deported from the United States on the ground that at the time of his arrival he was an alien immigrant not in possession of a valid immigration visa; that under date of November 23, 1945, the Board of Immigration Appeals directed that the deportation hearing of the plaintiff be reopened; that on or about April 26, 1949, the Board of Immigration Appeals denied plaintiff's application for suspension of deportation; that plaintiff thereafter filed an application for adjustment of status under Section 4 of the Displaced Persons Act of 1948, as amended; that plaintiff's application for adjustment of status under the Displaced Persons Act was denied on October 23, 1952, on the ground that the plaintiff did not lawfully enter the United States; that plaintiff's Motion for Reconsideration was denied on or about August 27, 1953; that on or about August 4, 1954, plaintiff filed an application for adjustment of status under Section 6 of the Refugee Relief Act of 1953; that in the early part of 1955 plaintiff was accorded what allegedly is called a hearing by the San Francisco office of the Immigration and Na-

turalization Service; that during the course of that proceeding, for the first time, counsel was afforded an opportunity to review all of the record relating to the plaintiff herein; that the documents contained in the Immigration and Naturalization Service record clearly establish that the plaintiff was a bona fide seaman who attempted to reship foreign from the United States following his arrival on March 8, 1941; that plaintiff's application for adjustment under the Refugee Relief Act was denied on or about June 16, 1955; that on or about August 23, 1955, plaintiff filed with the Board of Immigration Appeals a Motion to Reopen the Deportation Proceedings for the purpose of considering the evidence found in the Immigration and Naturalization Service records during the so-called Refugee Relief hearing; that under date of October 19, 1955, the Board of Immigration Appeals denied plaintiff's Motion to Reopen.

IV.

That the defendants, and each of them, have wilfully refused to consider relevant facts contained within the official records of the Immigration and Naturalization Service; that the decision is arbitrary, capricious and contrary to the evidence, and that the decision is erroneous as a matter of law.

V.

That the defendants, and each of them, denied plaintiff fair and impartial hearings, which complied with procedural due process of law, on his ap-

plications filed under Section 4 of the Displaced Persons Act, as amended, and Section 6 of the Refugee Relief Act.

VI.

That the plaintiff will suffer a legal wrong and will be adversely affected and aggrieved if the defendant is permitted to deport plaintiff from the United States; that plaintiff has no other adequate remedy at law.

Wherefore, plaintiff prays for a judgment of this Court declaring that the decision is in error; that the Immigration and Naturalization Service failed to grant plaintiff hearings which complied with procedural due process of law, and for such other and further relief as the Court may deem just and proper.

JACKSON & HERTOGS,
Attorneys for Plaintiff;

By /s/ JOSEPH S. HERTOGS.

[Endorsed]: Filed November 30, 1955.

[Title of District Court and Cause.]

ANSWER

Defendant Bruce G. Barber, as District Director, San Francisco District, Immigration and Naturalization Service, answers the complaint herein as follows:

First Defense

1. The Regional Commissioner, Southwest Region, Immigration and Naturalization Service, San Pedro, California, is an indispensable party to a review of decisions refusing adjustment of status under the Displaced Persons Act of 1948, or the Refugee Relief Act of 1953. The named defendant, Bruce G. Barber, District Director, San Francisco District, Immigration and Naturalization Service, who is the only person summoned before this court made no decision as to adjustment of status under either Act. Pursuant to regulations promulgated by the Attorney General, the decision is with the Regional Commissioner. 20 Fed. Reg. 6380 (1955). His office is located in San Pedro, California, in the Southern District of the State of California. This action is brought in the wrong district.

Second Defense

2. This court is without jurisdiction to review decisions denying adjustment of status under the Displaced Persons Act of 1948, or the Refugee Relief Act of 1953. Pursuant to the provisions of the statutes, the decisions are final, and not subject to judicial review.

Third Defense

Admits and avers as follows:

3. Admits the averments of paragraph II of the petition.

4. On March 8, 1941, plaintiff was issued a permit to enter this country as an alien seaman for a period not to exceed 60 days at Philadelphia, Pennsylvania. Plaintiff was arrested on May 22, 1941, in El Paso, Texas, as an alien illegally in the United States not in possession of a valid immigration visa. In a decision filed June 28, 1941, it was ordered that the alien be deported to Yugoslavia, at government expense, or in lieu thereof, that plaintiff be permitted to depart from the United States to any country of his own choice within 60 days. Upon review of this order, on April 9, 1942, the Board of Immigration Appeals ordered that the alien be deported, but that an order of deportation "not be entered at this time, but that the alien be required to depart from the United States, without expense, to any country of his choice within thirty days after notification of decision, on consent of surety." On October 3, 1945, plaintiff moved the Board of Immigration Appeals to reopen his case. The motion was granted on November 1, 1945. By a decision dated January 28, 1946, the order of April 9, 1942, was affirmed. On December 17, 1945, plaintiff applied for departure in lieu of deportation, and pre-examination. By an order dated April 30, 1948, plaintiff's petition for voluntary departure without an order of deportation was granted, and plaintiff's application for pre-examination was denied. Thereafter, in view of the fact that plaintiff had failed to voluntarily depart, in a decision dated July 15, 1947, it was ordered that the privilege of voluntary departure previously granted the alien be

withdrawn, and that the alien be deported to Yugoslavia at government expense on the ground that he was an immigrant not in possession of a valid immigration visa and not exempted from the presentation thereof by the acts or regulations. This decision was affirmed by the Board of Immigration Appeals on July 18, 1947, and a warrant of deportation was issued that day. Thereafter, on August 12, 1947, an application was received from the alien's attorney for discretionary relief on the ground that the alien had since married a native-born United States citizen. Thereafter, by order dated January 16, 1948, the Board of Immigration Appeals ordered the outstanding order and warrant of deportation withdrawn and the hearing reopened to permit the alien to apply for suspension of deportation. On July 2, 1948, after a hearing on the matter, it was ordered that suspension of deportation be denied. On December 18, 1947, an interlocutory decree of divorce was awarded against Anton K. Kocelj by his wife on the grounds of extreme cruelty. On April 26, 1949, the Board of Immigration Appeals affirmed the decision denying suspension of deportation. On June 21, 1949, plaintiff moved to reopen the proceedings. This motion was denied by the Board of Immigration Appeals in a written opinion on July 13, 1949. Thereafter plaintiff filed a motion in the Board of Immigration Appeals for an extension of thirty days time within which to depart to any country of his choice after notification of the decision rendered on April 26, 1949. This motion was denied by a written decision of the Board of Immigration

Appeals on July 22, 1949. Plaintiff thereafter applied for relief under the Displaced Persons Act of 1948, as amended, which application was denied on October 23, 1952. On February 20, 1953, plaintiff moved for reconsideration, which motion was denied on August 27, 1953. On August 5, 1954, plaintiff applied for adjustment of immigrant's status under Section 6 of the Refugee Relief Act of 1953. In a hearing before the Regional Commissioner, Southwest Region, Immigration and Naturalization Service, United States Department of Justice, San Pedro, California, the application for adjustment of status was denied on April 22, 1955. Thereafter, on August 23, 1955, plaintiff filed with the Board of Immigration Appeals a motion to reopen the deportation proceedings. In a decision filed October 19, 1955, the Board of Immigration Appeals denied the motion to reopen the deportation proceedings.

5. Defendant denies each and every averment of the petition not heretofore expressly admitted.

Fourth Defense

6. The complaint fails to state a claim against the defendant upon which relief can be granted.

Wherefore, defendant prays that plaintiff take nothing by its petition, that the action of the Board of Immigration Appeals be sustained, and that defendant have judgment for its costs of suit and for such other relief as the court considers proper.

Dated: June 8, 1956.

LLOYD H. BURKE,
United States Attorney;

By /s/ MARVIN D. MORGENSTEIN,
Assistant U. S. Attorney.

Affidavit of service by mail attached.

[Endorsed]: Filed June 8, 1956.

[Title of District Court and Cause.]

NOTICE OF MOTION FOR SUMMARY
JUDGMENT

To Defendants Above Named and to Lloyd H. Burke, United States Attorney and Marvin D. Morgenstein, Assistant United States Attorney, Post Office Building, Seventh and Mission Streets, San Francisco, California, His Attorneys:

Please Take Notice that on Monday, May 6, 1957, at the hour of 10:00 a.m., or as soon thereafter as the matter can be heard in the Law and Motion Department, United States District Court, Post Office Building, Seventh and Mission Streets, San Francisco, California, the plaintiff will move the Court to enter summary judgment for the plaintiff, pursuant to the provisions of Rule 56 of the Federal Rules of Civil Procedure.

Dated: April 17, 1957.

/s/ JOSEPH S. HERTOGS,
Attorney for Plaintiff.

Affidavit of service by mail attached.

[Endorsed]: Filed April 22, 1957.

[Title of District Court and Cause.]

NOTICE OF CROSS-MOTION FOR SUMMARY
JUDGMENT BY DEFENDANTS

Please Take Notice That upon the pleadings herein and the record of the proceedings of the Immigration and Naturalization Service, a certified copy of which will be offered as an exhibit, and upon all the proceedings herein, the defendants, by their attorneys, will make a cross-motion before this Court on Monday, May 6, 1957, at the hour of 9:30 a.m., or as soon thereafter as the matter can be heard in the Law and Motion Department, United States District Court, Post Office Building, Seventh and Mission Streets, San Francisco, California, for an order, pursuant to Rule 56 of the Federal Rules of Civil Procedure, directing that summary judgment herein be entered in favor of the defendant, and for such other and further relief as the Court may deem just.

Dated: April 29, 1957.

LLOYD H. BURKE,

United States Attorney;

By /s/ JAMES W. GRANT,

Assistant U. S. Attorney.

Affidavit of service by mail attached.

[Endorsed]: Filed April 29, 1957.

[Title of District Court and Cause.]

ORDER

The Court finds that previous immigration proceedings provided the plaintiff with a fair and impartial hearing. He was in no way deprived of due process of law. There is no evidence to support any arbitrary and capricious decision.

In view of the plethora of authorities in favor of the defendants and against the plaintiff, the cross-motion of the defendants for summary judgment is hereby granted.

It Is So Ordered.

In re Chow's Petition, S.D.N.Y., 1956,
146 F. Supp. 487.

Lukman v. Holland, E.D., Pa. 1956,
149 F. Supp. 312.

Mascarin v. Holland, E.D., Pa., 1956,
143 F. Supp. 427.

Dated: November 14th, 1957.

/s/ EDWARD P. MURPHY,
United States District Judge.

[Endorsed]: Filed November 14, 1957.

In the United States District Court for the
Northern District of California, Southern Division
Civil No. 35089

ANTUN KARLO KOCELJ,

Plaintiff,

vs.

BRUCE G. BARBER, as District Director, San
Francisco District, Immigration and Naturali-
zation Service, and HERBERT BROWNELL,
JR., as Attorney General of the United States,

Defendants.

SUMMARY JUDGMENT

The motion of the plaintiff for summary judgment and the cross-motion of the defendants for summary judgment pursuant to Rule 56 of the Rules of Civil Procedure having been submitted and the Court, after reviewing the administrative record, having found the plaintiff has been accorded due process of law with a fair and impartial hearing

and that there is no evidence of any arbitrary or capricious decision; and having heretofore on November 14, 1957, made and entered its order granting defendants' motion for summary judgment:

It Is Hereby Ordered, Adjudged and Decreed that the plaintiff is entitled to no relief, and the complaint and action are hereby dismissed and that the defendants have judgment of their costs in the sum of \$20.00.

Dated: November 21st, 1957.

/s/ EDWARD P. MURPHY,
United States District Judge.

[Endorsed]: Filed November 21, 1957.

Entered November 22, 1957.

[Title of District Court and Cause.]

NOTICE OF APPEAL

Notice is hereby given this 8th day of January, 1958, that Antun Karlo Kocelj hereby appeals to the United States Court of Appeals for the Ninth Circuit from the judgment of this Court entered on the 22nd day of November, 1957, in favor of the defendants and against the said Antun Karlo Kocelj, plaintiff.

JACKSON & HERTOGS,
Attorneys for Plaintiff;

By /s/ JOSEPH S. HERTOGS.

[Endorsed]: Filed January 14, 1958.

[Title of District Court and Cause.]

BOND FOR COSTS ON APPEAL

Whereas, the Plaintiff has appealed to the United States Court of Appeals, for the Ninth Circuit from the judgment of this court entered.

Now, Therefore, in consideration of the premises and of such appeal, the undersigned, United Pacific Insurance Company, a corporation duly organized and existing under the laws of the State of Washington, and duly authorized to transact a general surety business in the State of California, does undertake and promises on the part of the Plaintiff, to secure the payment of costs if the appeal is dismissed, or the judgment affirmed, or such costs as the Appellate Court may award if the judgment is modified, not exceeding the sum of Two Hundred Fifty and No/100 (\$250.00) Dollars, to which amount it acknowledges itself bound.

It is expressly agreed by the Surety that in case of breach of any condition hereof, the above-entitled Court, may proceed summarily in the above-entitled action in which this bond is given, to ascertain the amount which the Surety is bound to pay on account of such breach and render judgment therefor against the Surety and award execution therefor, all as provided by and in accordance with the intent and meaning of Section 73C of the Federal Rules of Civil Procedure.

In Witness Whereof, the corporate seal and name of the said Surety Company is hereto affixed and

attested at San Francisco, California, by its duly authorized officer, this 14th day of January, 1958.

UNITED PACIFIC
INSURANCE COMPANY,

By /s/ M. CULLEN,
Attorney-in-Fact.

[Endorsed]: Filed January 15, 1958.

[Title of District Court and Cause.]

EXCERPT FROM DOCKET ENTRIES

1955

Nov. 30—Filed complaint—issued 2 summons.

* * *

Mar. 27—Filed notice by deft. of motion to dismiss,
April 9, 1956.

* * *

Apr. 9—Ordered, motion to dismiss denied. (Ham-
lin.)

June 8—Filed answer of Bruce G. Barber.

1957

* * *

Apr. 22—Filed notice and motion by plaintiff for
summary judgment, May 6, 1957.

Apr. 29—Filed notice and motion by defendants of
cross-motion for summary judgment, May
6, 1957.

1957

May 6—Ordered after hearing, memos, to be filed 20-10-5 days and motions for summary judgment and case cont'd. to June 10, 1957, for submission. (Murphy.)

June 10—Ordered case continued to June 25, 1957, for submission. (Murphy.)

* * *

Sept. 9—Ordered after hearing, counsel for defendant's motion to submit matter on administrative record denied. Memos. ordered filed 10-5 days and case continued to September 26, 1957, for submission. (Murphy.)

* * *

Sept. 25—Ordered case continued to Sept. 27, 1957, for submission. (Murphy.)

Sept. 27—Ordered after hearing, plaintiff to Oct. 4, 1957, to reply to reply brief of defendant and matter to be submitted at later date. (Murphy.)

* * *

Nov. 12—Ordered case submitted. (Murphy.)

Nov. 14—Filed order, cross-motion of defendants for summary judgment granted. (Murphy.)

Nov. 14—Mailed copies order to counsel.

Nov. 22—Entered summary judgment—filed Nov. 21, 1957—that plaintiff is entitled to no relief and defendants to recover costs in sum \$20.00. (Murphy.)

Nov. 22—Mailed notices.

1958

Jan. 14—Filed notice of appeal by plaintiff.

Jan. 14—Filed appellant's designation of record on appeal.

Jan. 15—Mailed notices.

Jan. 15—Filed appeal bond in sum of \$250.00.

[Title of District Court and Cause.]

CERTIFICATE OF CLERK TO RECORD
ON APPEAL

I, C. W. Calbreath, Clerk of the United States District Court for the Northern District of California, hereby certify the foregoing and accompanying documents and exhibits, listed below, are the originals filed in this Court in the above-entitled case and constitute the record on appeal herein as designated by the attorneys for the appellant:

Excerpt from docket entries.

Complaint. (Petition for Review.)

Answer.

Motion of Plaintiff for Summary Judgment.

Motion of Defendant for Summary Judgment.

Order Granting Motion of Defendant for Summary Judgment.

Summary Judgment.

Notice of Appeal.

Appeal Bond. (Photostat copy.)

Appellant's Designation of Record on Appeal.

Defendants' Exhibit "A." (Certified record of Immigration and Naturalization Service.)

In Witness Whereof, I have hereunto set my hand and affixed the seal of said District Court this 18th day of February, 1958.

[Seal]

C. W. CALBREATH,
Clerk;

By /s/ MARGARET P. BLAIR,
Deputy Clerk.

[Endorsed]: No. 15895. United States Court of Appeals for the Ninth Circuit. Antun Karlo Kocelj, Appellant vs. Bruce G. Barber, District Director, Immigration, and Herbert Brownell, Jr., as Attorney General of the United States, Appellees. Transcript of Record. Appeal from the United States District Court for the Northern District of California, Southern Division.

Filed February 18, 1958.

Docketed: February 20, 1958.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the
Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit

No. 15895

ANTUN KARLO KOCELJ,

Appellant,

vs.

BRUCE G. BARBER, as District Director, San
Francisco District, Immigration and Naturali-
zation Service, and HERBERT BROWNELL,
JR., as Attorney General of the United States,

Appellees.

POINTS ON APPEAL

Comes Now the appellant, Antun Karlo Kocelj,
by and through his attorney, Joseph S. Hertogs, and
files herein the Points on Appeal on which appellant
intends to rely in the appeal of the above-entitled
matter:

I.

That the District Court erred in concluding that
the decision of the Immigration and Naturalization
Service is based upon reasonable, substantial and
probative evidence.

II.

That the District Court erred in concluding that
the appellant had been given a fair and impartial
administrative hearing.

III.

That the District Court erred in concluding that
the appellant was accorded due process of law under

the Fifth Amendment to the Constitution of the United States.

IV.

That the District Court erred in concluding that all of the circumstances disclosed in the record did not warrant judicial intervention.

/s/ JOSEPH S. HERTOGS,
Attorney for Appellant.

[Endorsed]: Filed March 18, 1958.

[Title of Court of Appeals and Cause.]

STIPULATION AND ORDER

It is hereby stipulated by and between counsel for the appellant and counsel for appellees that all exhibits introduced at the time of trial of the above-entitled matter may be considered in their original form without printing.

/s/ JOSEPH S. HERTOGS,
Attorney for Appellant.

/s/ LLOYD H. BURKE,
United States Attorney;

/s/ CHARLES ELMER COLLETT,
Asst. United States Attorney,
Attorneys for Appellees.

[Endorsed]: Filed March 18, 1958.

No. 15902 ✓

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

YOICHI FUJII,

Appellant,

vs.

JOHN FOSTER DULLES, Secretary of State of the United
States,

Appellee.

Appeal From the United States District Court for the
District of Hawaii.

APPELLANT'S OPENING BRIEF.

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76 North King Street,
Honolulu 8, Hawaii,

A. L. WIRIN,

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257 South Spring Street,
Los Angeles 12, California,

Attorneys for Plaintiff-Appellant.

FILED

MAY 15 1958

PAUL P. O'BRIEN, CLERK

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No. 15902
IN THE
United States Court of Appeals
FOR THE NINTH CIRCUIT

YOICHI FUJII,

Appellant,

vs.

JOHN FOSTER DULLES, Secretary of State of the United
States,

Appellee.

Appeal From the United States District Court for the
District of Hawaii.

APPELLANT'S OPENING BRIEF.

**Statement of Pleadings and Facts Disclosing
Jurisdiction.**

This is an appeal from Summary Judgment in favor of defendant [R. 42-43].

The complaint is under Section 503 of the Nationality Act of 1940 (8 U. S. C. (1946 Ed.) 903; 54 Stat. 1171) as preserved by Section 405(a), Immigration and Nationality Act of 1952 (note to 8 U. S. C. 1101; 66 Stat. 280) for a declaration pursuant to that section that plaintiff is a national of the United States [R. 26-32].

The District Court had jurisdiction under said sections. The Summary Judgment was filed and entered on December 20, 1957 [R. 43]. Notice of Appeal was filed on December 20, 1957 [R. 44].

This Court has jurisdiction to review the Summary Judgment under 28 U. S. C. 1291 and 1294(1).

Statement of the Case.

Statutes.

There are no statutes directly involved in this appeal. The complaint was filed on June 4, 1956 [R. 30]. Defendant thereafter filed a motion to dismiss on the ground of lack of jurisdiction of the subject matter [R. 33-34] apparently bringing into question whether the District Court had jurisdiction under said 8 U. S. C. (1946 Ed.) 903 and Section 405(a) of the Immigration and Nationality Act of 1952 (note to 8 U. S. C. 1101), both of which are set out in the margin.¹ However, before that motion was ruled upon, defendant filed a motion for summary judgment [R. 35-36] on the ground "that there

¹8 U. S. C. 903, under which the complaint was filed, provides in pertinent part:

"If any person who claims a right or privilege as a national of the United States is denied such right or privilege by any Department or agency, or executive official thereof, upon the ground that he is not a national of the United States, such person . . . may institute an action against the head of such Department or agency . . . in the district court of the United States for the district in which such person claims a residence for a judgment declaring him to be a national of the United States"

Section 405a of the Immigration and Nationality Act, 1952 (66 Stat. 166 *et seq.*), the "savings clause" provides in pertinent part (note to 8 U. S. C. 1101):

"(a) Nothing contained in this Act, unless otherwise specifically provided therein, shall be construed to affect the validity of any . . . proceeding which shall be valid at the time this Act shall take effect; or to affect any prosecution, suit, action, or proceedings, civil or criminal, brought, or any status, condition, right in process of acquisition, act, thing, liability, obligation, or matter, civil or criminal, done or existing, at the time this Act shall take effect; but as to all such prosecutions, suits, actions, proceedings, statutes (*sic*), conditions, rights, acts, things, liabilities, obligations, or matters the statutes or parts of statutes repealed by this Act are, unless otherwise specifically provided therein, hereby continued in force and effect."

is no genuine issue as to any material fact establishing that the questions presented by the Complaint filed herein have been decided upon the merits by this Court in Civil No. 1300, Yoichi Fugii v. John Foster Dulles." Whereupon the court below considered both motions as "one for summary judgment" [R. 39].

Facts.

Defendant filed no affidavits and there is no refutation nor any question as to the truth of the facts alleged in the complaint.

The complaint (No. 1487 in the Record) alleged, *inter alia*, that plaintiff was born in Honolulu, Territory of Hawaii [R. 26], that he claims Hawaii as his permanent residence [R. 27], that defendant is the Secretary of State of the United States and the head of the Department of State, that the District Court had jurisdiction under 8 U. S. C. 903 and section 405(a) of the Immigration and Nationality Act of 1952 (note to 8 U. S. C. 1101) [R. 27], that plaintiff served in the Japanese Armed Forces and, in 1947, voted in Japan [R. 27]; that plaintiff's military service and his voting was not his free and voluntary act [R. 27]; that in 1948 plaintiff's application to return to the United States was not accepted by the United States Consul in Japan because of the then Occupation [R. 28]; that in November, 1951, plaintiff received a letter from the United States Consul outlining the procedure and documents to be followed by an American citizen of Japanese ancestry resident in Japan who seeks to be registered, or who seeks a passport as an American citizen [R. 28]; that pursuant to that letter he obtained the documents as soon as he could and on October 29, 1952, filed a formal application for passport as an American citizen together with all neces-

sary documents [R. 29]; that the Consul did not act on said application until December 29, 1952, knowing during November and December, 1952 that the Immigration and Nationality Act of 1952 was to go into effect on December 24, 1952 [R. 29]; that on December 29, 1952, the Consul issued to plaintiff a Certificate of Loss of Nationality [R. 29] and that said action was approved by the State Department in Washington, D. C., on July 23, 1953 [R. 30].

The prayer was for a judgment declaring that plaintiff is a National of the United States and that he did not lose his United States citizenship by reason of his service in the Japanese Armed Forces or by reason of his having voted in an election in Japan in April, 1947 [R. 30.]

Thereafter defendant filed a Motion to dismiss on the ground that the Court lacked jurisdiction of the subject matter [R. 33-34]. Before said motion was heard or ruled upon, defendant filed a motion for summary judgment "on the ground that the question presented by the Complaint filed herein have been decided *upon the merits* by this Court in Civil No. 1300, Yoichi Fujii v. John Foster Dulles and that the Defendant is entitled to judgment as a matter of law" [R. 35-36; italics added].

The court below filed a written ruling on the motions to dismiss and for summary judgment [R. 37-41], considering both motions "as one for summary judgment" [R. 39], and ruled that by reason of No. 1300 in that court [R. 40]: "there being no genuine issue as to any material fact, as a matter of law, the defendant is entitled to Summary Judgment" [R. 41] and it granted the motions [ibid.]. In other words, without any evidence having been introduced or heard, and without even an allegation by the Government disputing the facts alleged

in the complaint, or even a suggestion by it that the facts are not true, the court below has, apparently, adjudged, *on the merits*, that plaintiff is not a national of the United States; this, in the face of the undisputed, indeed—admitted—allegation that plaintiff was born in the United States and did not voluntarily serve in the Japanese Armed Forces nor voluntarily vote in Japan.

The proceedings in No. 1300 in the Court below, of which the court took judicial notice [R. 40], was likewise a proceeding in which no evidence was taken and no facts counterweighing plaintiff's allegations were advanced by the Government.

In that case, the complaint, filed on December 23, 1952 [R. 6], alleged, *inter alia*, that plaintiff was born in the United States and claims the Territory of Hawaii as his permanent residence [R. 3]; that defendant, Dulles, is the Secretary of State [R. 3]; that plaintiff served in the Japanese Armed Forces and voted in Japan [R. 4]; that said service and voting were not plaintiff's free and voluntary acts [R. 5]; that prior to the filing of the complaint, plaintiff had executed a petition with the American Consular Service in Japan for a passport to come to the United States as an American Citizen [R. 4]; that the American Consulate had not yet made a determination as to said petition [R. 4]; that the non-action and inexcusable delay on the part of the Consulate is a denial of plaintiff's rights as a citizen of the United States [R. 5]. The prayer asked for a judgment and decree adjudging that plaintiff is a citizen and/or national of the United States and entitled to a passport [R. 6].

On February 11, 1953, defendant filed a motion to dismiss [R. 6-7]. Before this motion was heard, plaintiff filed a motion for leave to file an amended complaint at-

tached thereto [R. 7-10]. Said amended complaint, in contrast to the original complaint which had alleged [R. 4] that no action had been taken by the Consular Service on plaintiff's position for a passport, alleged [R. 9] that the Service had issued to plaintiff a Certificate of the Loss of the Nationality of the United States.

Thereafter the Court granted defendant's motion to dismiss the complaint [R. 46] and allowed 30 days to amend [R. 46].

Within said 30 days [R. 46], plaintiff filed an Amended and Supplemental Complaint [R. 11-12] in which he alleged, on the subject of the action taken by the American Consular officials in Japan, that he filed his application on October 29, 1952 [R. 11]; that the Consular officials did not recognize plaintiff as a citizen of the United States on the day he applied therefor, but instead, on December 29, 1952, executed as to him a Certificate of the Loss of the Nationality of the United States on the ground that he had lost his United States citizenship by reason of his service in the Japanese Armed Forces [R. 12]; and that said Certificate was approved by the Department of State in Washington, D. C., on July 23, 1953 [R. 12.]

Defendant thereupon filed a Motion to Strike and Motion to Dismiss Amended and Supplemental Complaint [R. 13-14]. Defendant asked that the allegations in the Amended and Supplemental Complaint as to the actions taken by the consular officials in Japan and the State Department in Washington, D. C., on plaintiff's application be stricken [R. 13]; said allegation being [R. 12]:

“ . . . Instead, on December 29, 1952, the American Vice Consul at Tokyo executed as to Plaintiff a Certificate of the Loss of the Nationality of the

United States on the ground that Plaintiff had lost his United States citizenship by reason of his said service in the Japanese Armed Forces. Said Certificate was approved by the Department of State in Washington, D. C., on July 23, 1953, and sent to the plaintiff by the said Consular Office on September 25, 1953.”

The motion to dismiss portion of defendant’s motions was on the ground that the complaint failed to state a claim upon which relief can be granted [R. 13].

In ruling on these two motions, the court *first* granted the motion to strike the portions as requested by defendant [R. 16] and *then*² ordered the cause and the petition dismissed [ibid.].

Thereafter, plaintiff filed motions (1) to set aside and relieve plaintiff of (a) the Order of Dismissal and (b) of the Order striking portions of the Amended and Supplemental Complaint [R. 23-24] and (2) for leave of court to file an amendment to the amended and supplemental complaint [R. 17-18]. Prior to the time of the ruling on these motions, plaintiff filed his complaint in No. 1487 [R. 30], the proceedings in which this appeal is taken. Thereafter the court denied plaintiff’s motion in No. 1300 to set aside the Order of Dismissal [R. 47]. Notice of Appeal was filed [R. 48]. The appeal was dismissed by stipulation [R. 38].

Thereafter summary judgment for defendant was entered in this case [R. 43]. Hence this appeal.

²The words “first” and “then” are italicized for, as will be seen in the Argument below, this order of events may have a bearing on the outcome of the case.

Specification of Errors.

1. The District Court erred in granting defendant's Motion to Dismiss;
2. The District Court erred in granting defendant's Motion for Summary Judgment;
3. The District Court erred in entering Summary Judgment for defendant.

ARGUMENT.

Summary of Argument.

Without the Government having controverted any factual allegation of plaintiff, including the allegation that plaintiff was born in the United States and that acts stated in the law to be expatriating had not been performed by him voluntarily, and in the face of the clear law that at the minimum plaintiff is at least entitled to his day in court (*Junso Fugii v. Dulles* (C. A. 9, 1955), 224 F. 2d 906) and that this is a case where, before there can be a declaration that a native-born citizen has expatriated himself, the Government has a heavy burden of proof to show by clear, convincing and unequivocal evidence that the act was voluntarily performed (*Nishikawa v. Dulles*, 356 U. S., 2 L. Ed. 2d 659), appellant is faced here with a judgment which, apparently, adjudicates that he is not a citizen of the United States. The basis for this startling state of events is the trial court's ruling that, because a previous case was dismissed by the court *not on the merits*, but on the erroneous view that it had no jurisdiction of the subject of the

action, there is no right to sue in this case for a judgment on the merits.

Whatever else may be the rules of *res judicata*, it is clear that a judgment on the merits cannot be given unless the merits have been adjudicated. Not only was this not done in this case, but the present suit in which this appeal is taken contains allegations, the sufficiency of which was not adjudicated in the previous suit.

Accordingly, plaintiff is entitled not only to a modification of the judgment so as to make clear that it is not a judgment on the merits of the question as to whether he lost his United States citizenship, but he is also entitled to a complete reversal and given his court trial as directed by Congress in 8 U. S. C. 903.

I.

The Savings Clause of the Immigration and Nationality Act of 1952 Preserves the Right to File Suit for a Declaration of Nationality Under 8 U. S. C. 903 Where the Application for Passport or Registration Was Filed Before the Effective Date of the 1952 Act.

The court below apparently did not give consideration to this question raised by defendant's motion to dismiss for lack of jurisdiction [R. 33-34] because it decided the case as one for summary judgment [R. 39, 41, 43]. The point does not require extended discussion, however, because it is clear that the law as contended for by plaintiff has been settled by this court in *Junso Fugii v. Dulles*, 224 F. 2d 906 (1955), where the factual situation before the Consulate was identical with that here.

II.

Summary Judgment, Based on a Previous Case Being Res Judicata, Cannot Be Granted, and Certainly Cannot Be Granted on the Merits, Where the Previous Case Did Not Adjudicate the Merits and Was Dismissed Because of the Court's Erroneous View That It Had No Jurisdiction.

While it is true that the court below recognized [R. 37] the rule to be "that the law and the facts (should) be construed in such a manner as to avoid a loss of citizenship,"³ it is submitted that in this case the court did just the opposite and construed both the facts and the law strictly against the citizen so as to effect loss of citizenship. The mere statement of the problem posed and the result ordered by the judgment below suggests that if such be the result (plaintiff deprived of his day in court on the merits), there is something wrong with a rule of law which would permit of such injustice. But this case need not be disposed of by *a priori* reasoning; the law itself requires that there be a reversal herein.

A.

The Doctrine of Res Judicata Does Not Apply Unless There Was a Previous Judgment on the Merits.

The rule is thus stated at 50 C. J. S. 51:

"A judgment in a suit will operate as a bar to a subsequent suit on the same cause of action *if, and only if*, the judgment and the proceedings leading up thereto involved, or afforded full legal opportunity for, an investigation and determination of the merits of the suit." (Italics added.)

³Citing *Schneiderman v. United States*, 302 U. S. 118, 122; *Junso Fugii v. Dulles*, 224 F. 2d 906, 907 (C. A. 9, 1955).

We believe this rule to be a correct statement of the law. Defendant cannot contend in the case at bar that there was an adjudication on the merits. On the contrary he has attempted (thus far successfully) to prevent that very thing.

Corpus Juris Secundum, in support of its statement of the rule, cites many cases, including reference to Judge Haney's concurring opinion in this court's decision in *Suren v. Oceanic S.S. Co.*, 85 F. 2d 324, 325 (C. C. A. 9, 1936):

"A judgment in the prior action, *unless rendered on the merits*, is not *res judicata*."

The Supreme Court has spoken on the subject a number of times:

Walden v. Bodley, 14 Pet. (U. S.) 156, 161:

"As the first bill was dismissed for want of jurisdiction, and the second by the complainants, at rules, in the clerk's office, it is clear that neither can operate as a bar to the present bill. A decree dismissing a bill generally, may be set up in bar of a second bill, having the same object in view; but the court dismissed the first bill on the ground that they had no jurisdiction, which shows that the case was not heard on the merits . . ."

Smith v. McNeal, 109 U. S. 426, 27 L. Ed. 986, 987:

"It is well settled that the judgment of a court dismissing a suit for want of jurisdiction does not conclude the plaintiffs' right of action."

Hughes v. United States, 4 Wall. (U. S.) 232, 18 L. Ed. 303, 305:

". . . If the first suit was dismissed for defect of pleadings, or parties, or a misconception of the

form of proceeding, or the want of jurisdiction, or was disposed of on any ground which did not go to the merits of the action, the judgment rendered will prove no bar to another suit.”

Cf. N.L.R.B. v. Denver Bldg. & Constr. Tr. Council,
341 U. S. 675, 681, 682:

“ . . . We do not agree (that the issue is res judicata). The District Court (in the first case) did not have before it the record on the merits . . . ”

This Court is in agreement.

In *Werner v. United States*, 198 F. 2d 882 (C. A. 9, 1952), the first case was dismissed by the District Court for want of jurisdiction over the United States. The Court of Appeals affirmed (188 F. 2d 266). In this second case the United States urged the previous case as a bar. The court rejected the plea and reversed the trial court which had accepted it. The court said (198 F. 2d at 883):

“ . . . Appellant is entitled to his day in court as to whether in his present case he has stated a cause of action and, if he has, whether he has sustained the requisite proof.”

In *Sachs v. Ohio National Life Insurance Co.*, 148 F. 2d 128, 132 (C. C. A. 7, 1945), cert. den. 326 U. S. 753, the court said:

“ . . . We think no authority need be cited for the proposition that a ruling is not res judicata when made in a case subsequently dismissed for want of jurisdiction . . . ”

Picturesquely putting the proposition, Judge Carpenter, in *Wayne County Securities Co. v. Hughitt*, 228 Fed. 816, 818 D. C. N. D. Ill., 1915) said:

“ . . . (T)he municipal court having dismissed the cause of action for want of jurisdiction, the parties are as if no suit had ever been brought. It is not *res judicata* of anything.”

B.

The Order of Dismissal in No. 1300 Was Not on the Merits.

It cannot be seriously contended that the dismissal in No. 1300 was on the merits. It simply cannot be accepted that the District Court's Order of Dismissal in that case [R. 15-16] before trial was an adjudication that Yoichi Fujii is not a citizen of the United States; that he lost his native acquired citizenship by reason of his military service and voting in Japan and that said military service and voting were voluntary.⁴ The rule is that “the party relying upon *res judicata* has the burden of showing that the decree was on the merits.” (*Sacks v. Stecker*, 62 F. 2d 65, 67 (C. C. A. 2, 1932).) We do not believe that defendant can point to, or even properly suggest, anything showing that the court in its dismissal of No. 1300 either did, or intended to, adjudicate the substance of plaintiff's claim to citizenship.

To supply this deficiency, reliance is placed [R. 39] on the technical wording of Rule 41(b), to which we now turn.

⁴Without which, of course, there could be no loss of citizenship (*Perkins v. Elg*, 307 U. S. 325, 334). And in the light of the heavy burden on the Government to *prove* that the conduct was voluntary (*Nishikawa v. Dulles*, 356 U. S. . . . , 2 L. Ed 2d 659), the suggestion that the pre-trial dismissal of No. 1300 adjudicated that fact, is without basis.

C.

Rule 41(b), Federal Rules of Civil Procedure, Does Not Apply to the Ruling, Before Trial in No. 1300.

“The place that Rule 41(b) relating to dismissal of actions occupies in the numerical order of rules, as part of chapter entitled ‘Trials,’ tends to characterize the rule primarily as controlling the action at or after trial and does not apply to a dismissal of the complaint to insufficient pleading.”

2 Baron & Holtzhoff, Sec. 917, p. 635, n. 5.

The authority for Baron and Holtzhoff’s statement is *Russo v. Sofia Bros.*, 2 F. R. D. 80 (D. C. N. Y., 1941). This case has never been questioned and has been cited with approval on the point (*Adams v. Jarka Corporation*, 8 F. R. D. 571, 574 (S. D. N. Y., 1948)).

In the *Russo* case, the court said, after quoting Rule 41(b) (2 F. R. D. at 81, 82):

“Clearly, there has been no trial of the issues. Manifestly all that has heretofore been decided is that the *complaint then before the Court* did not state a cause of action against Lorber. . . . In other words, objectively considered, there has been no disposition of plaintiff’s claim on the merits. Are we constrained by a fiction to so treat it by the command of Rule 41?

“ . . .

“There is nothing in the note (of the Reporter to the Advisory Committee on the rules) to indicate the applicability of the Rule to a preliminary motion addressed to a pleading. To the contrary, its inapplicability is at least inferentially suggested. . . . These discussions (of the Symposium on the Rules under the auspices of the American Bar Association)

reveal the Rule in its primary function, as a device during trial to prevent the recurrence of litigation that had reached that advanced stage.

“ . . .

“To extend the operation of this rule to the instant motion would, I believe, create a penalty and a forfeiture which was not contemplated by the framers of the Rule”

D.

A Decision on a Motion to Dismiss for Failure to State a Claim Cannot and Does Not Decide Any Issue of Fact.

Passing from reliance upon Rule 41(b) support is next sought [R. 40] from Rule 12(b)(6).

But this misconceives the function of the motion to dismiss for failure to state a claim. We repeat again our belief in the impossibility for defendant to show that the court either did, or intended to, pass upon the question as to whether plaintiff is or is not a citizen or whether he did or did not lose his citizenship in Japan.⁵

“If the defendant, whether on demurrer, motion, verdict or otherwise, obtains judgment in his favor on a ground not involving the substance of the plaintiff’s cause of action, the cause of action is not extinguished thereby.” (Rest. Judgments, p. 194.)

How, then, can it be claimed that the dismissal in No. 1300 involved the substance of the plaintiff’s claim?

“The motion (to dismiss for failure to state a claim upon which relief can be granted) raises only a question of law.” (1 Baron & Holtzhoff, Sec. 356, p. 642.) How,

⁵Indeed, the court below acknowledged [R. 39] “that a motion to dismiss cannot be substituted for a trial on the merits.”

then, can it be asserted that the facts upon which plaintiff's claim to citizenship is based were passed upon?

"Questions of fact will not ordinarily be determined on such a motion" (*ibid*). Can defendant claim that the Court did determine the facts of plaintiff's claim in its decision dismissing No. 1300? We think not.

E.

The Court's Order of Dismissal in No. 1300 Was Not on the Merits But Was for Lack of Jurisdiction.

We think there can be no real disagreement on this point. In its Order of Dismissal dated September 23, 1954, the Court recited [R. 15-16] that it had granted the defendant's first motion to dismiss "because at the time the instant suit was filed the petitioner had not actually been denied a passport or other right or privilege as a national of the United States." It then recited [R. 16] that it had given plaintiff leave to amend to state such facts. And it then recited [R. 16] that the amended complaint which was filed "contained allegations which were not amendatory matter which the Court allowed or anticipated allowing in the leave to file an amended complaint." Accordingly it granted defendant's motion to strike those supplementary allegations which spoke of a date later than the date of the filing of the complaint. And having granted the motion to strike, the Court then dismissed the complaint [R. 16].^{5a}

Thus it is seen that the court's Order of Dismissal can in no way be interpreted as being on the merits.

^{5a}It should be pointed out, of course, that this ruling by the District Court was before [Sept. 23, 1954; R. 17] this Court's ruling in *Junso Fujii v. Dulles*, 224 F. 2d 906 (July 14, 1955).

And it is also seen that the order of dismissal of September 23, 1954, was for the same reasons and on the same ground as the Court's May 28, 1954, Ruling on Defendant's Motion to Dismiss. An examination of the Court's May 28, 1954, Ruling is therefore in order.⁶

The May 28, 1954, ruling is stated in terms of "no claim is stated within the meaning of Section 503 of the Nationality Act of 1940" (Appx. A, p. 3). But an examination of the ruling shows that what the court had in mind was that there was no jurisdiction. Thus the court said (Appx. A, p. 2):

"Section 503 of the Nationality Act of 1940, 8 USCA Section 903, conferred restricted jurisdiction on this court. . . . Inasmuch as Section 503 was repealed as of December 24, 1952, the complaint must clearly allege that such denial of a right or privilege had occurred prior to that date . . .

". . . Nothing in the amended complaint definitely shows that plaintiff had been denied a right or privilege as a national of the United States prior to December 23, 1952, the time the action was instituted. Without such allegation in the amended complaint, no claim is stated within the meaning of Section 503 of the Nationality Act of 1940." (Italics added.)

Thus read⁷ it is clear that the basis for the Court's ruling is its belief that it had no jurisdiction. And it is

⁶Although appellant designated [Clk. Tr. p. 37] that "the complete record and all the proceedings and evidence in the action" be the record on appeal, this order of May 28, 1954, was not transmitted to this Court and, accordingly, is not in the printed record. It is set out hereinafter as Appendix "A."

⁷Even without having in mind the Supreme Court's admonition that in this case the facts and law must be read as reasonably as possible in favor of plaintiff.

likewise manifest that, by the same reasoning, when the Court in its September 23, 1954, Order of Dismissal said [R. 16] "that the complaint does not state a cause of action against the defendant upon which relief can be granted," that ruling was based upon its belief of the *restricted jurisdiction* granted it under Section 503 of the 1940 Nationality Act.

To read the Court's Order of Dismissal [R. 16] as being not on jurisdictional grounds would be to favor form over substance. But this cannot be done. Even in cases not involving citizenship the court will look to substance rather than to form (*Young v. Higbee Co.*, 324 U. S. 204, 209; *Wilkinson v. McKimmie*, 229 U. S. 590; 57 L. Ed 1342, 1343).⁸

So, here.

III.

The Order of Dismissal of No. 1300 Is Not Res Judicata.

A.

A Dismissal for Lack of Jurisdiction Does Not Bar a Subsequent Suit.

Assuming, as we believe to be without question, the Order of Dismissal of No. 1300 was for lack of jurisdiction, that Order does not bar this present suit.

In *Rand v. United States*, 48 Fed. 357, 358 (D. C. Me., 1891) (affd. sub nom. *United States v. Rand*, 53 Fed. 348 (C. A., 1892)) the first case, *Rand v. United States*, 36

⁸This is true where the motion to dismiss was stated to be for failure to state a claim, but actually was decided by the court on other grounds. In such a case, the second court will look beyond the title to what was actually argued and decided. Cf. *Mullen v. Fitzsimmons, etc.*, 172 F. 2d 601, 602 (C. A. 7, 1948).

Fed. 671 (D. C. Me., 1888), was for certain fees claimed by a Commissioner. As to part of them the United States objected on the ground that the court did not have jurisdiction. The District Court agreed with the Government and disallowed those claims on that ground. No appeal was taken. Later an appellate court decision in another case was rendered to the effect that the court did have jurisdiction over the items. The second suit, *Rand v. United States*, 48 Fed. 357 (D. C. Me., 1891), was also for amounts claimed by the Commissioner and included the *same items* which previously had been rejected for want of jurisdiction in the court. The court held the claims could be proved, saying (48 Fed. at 358):

“ . . . A portion of these items were included in the proceeding by this same petitioner in 1888, and was then, upon authority of *Bliss v. U. S.*, 34 Fed Rep. 781 held not to be within the jurisdiction of this court. *Rand v. U. S.*, 36 Fed. Rep. 671. *Such disposition of the claim for supposed want of jurisdiction to pass upon its merits does not operate as a bar to this petition. . . .*” (Italics added.)

This decision, including its reasoning and conclusions, was affirmed on appeal (53 Fed. 348 (C. C. A. 1, 1892).)

Nor is the *Rand* case alone. In 3 Baron & Holtzhoff, Section 1240, pp. 109-110, it is stated:

“ . . . If the court has no jurisdiction, it has no power to enter a judgment on the merits but must dismiss the action. . . . (O)ne district court, inadvertently perhaps, granted a summary judgment in favor of a defendant upon the ground that the court lacked jurisdiction of the case. Such a judgment like a judgment of dismissal for want of jurisdiction is not *res judicata* of subsequent action in a court of competent jurisdiction”

Bunker Hill & Sullivan Mining & Concentrating Co. v. Shoshone Min. Co., 109 Fed. 504, 507-508 (C. C. A. 9, 1901), states the law thus:

“ . . . It (the first suit) was dismissed for want of jurisdiction, and for no other reason. Such a judgment cannot be pleaded in bar. *The matter stands as if no proceedings were ever had. It is as if no suit had ever been brought. It is a blank. No refinement of words, or ingenious argument of learned counsel, can infuse life into proceedings that are dead, null, and void.* In the very nature of the case, it is impossible to sustain the proposition of appellee's counsel that any point was decided by the court by the dismissal that would go to the merits of the action. The fact of dismissal for want of jurisdiction proves conclusively that the case was not heard on its merits. (Italics added.)

“These general principles are well settled. The authorities bearing upon the subject all declare that, where an action is dismissed on the sole ground that the court has no jurisdiction of the subject-matter of the suit or of the parties, there cannot be any jurisdiction of the merits, and no bar to another action for the same cause (citations).

“In *Hughes v. U. S.*, 4 Wall. 232, 237, 18 L. Ed. 303, the court, in discussing this question, said:

“‘In order that a judgment may constitute a bar to another suit, it must be rendered in a proceeding between the same parties or their privies, and the point of controversy must be the same in both cases, and must be determined on its merits. If the first suit was dismissed for defect of pleadings or parties, or a misconception of the form of proceeding, or the want of jurisdiction, or was disposed of on any ground

which did not go to the merits of the action, the judgment rendered will prove no bar to another suit.'

"In *Freem. Judgm.*, supra, it is said:

" 'There can be no doubt that the dismissal of an action for want of jurisdiction is not a judgment on the merits, and cannot prevent the plaintiff from subsequently prosecuting his action in any court authorized to entertain and determine it.' "

Illinois Central R. Co. v. Mississippi Public Service Commission, 135 Fed. Supp. 304, 306 (S. D. Miss., 1955), stated the general rule thus:

" . . . (T)here is no doctrine of exhaustion of judicial remedies. If a judgment of dismissal is rendered on jurisdictional grounds, the losing party may accept it; and, instead of seeking a review, may institute another action where one will not be met by the jurisdictional bar."

And see *Williams v. Minn. Mining & Mfg. Co.*, 14 F. R. D. 1, 8, 9 (S. D. Cal., 1953), where the court said:

"The long settled general rule is that a judgment of dismissal for want of jurisdiction is not *res judicata* as a final decision upon the merits, and consequently does not operate as a bar to a subsequent action before some appropriate tribunal . . .

"The same rule applies for like reasons to orders made prior to a determination of lack of jurisdiction . . .

"So, also, with respect to findings as to jurisdictional facts made incident to a determination of lack of jurisdiction. These are held not to be *res judicata* so as to estop a party to assert the contrary in a

collateral proceeding, since the collateral estoppel doctrine is not applicable to such 'incidental' determination of fact."

McNamara v. Home Land & Cattle Co., 121 Fed. 797 (C. C. A. 7, 1903), was an action for damages for breach of contract. The defendant claimed that a previous action on the contract barred the present suit. The court held this not to be the case because there had been no adjudication of the facts of the case. The court said (121 Fed. at 800):

" . . . Whether we look at the record of that (first) cause, with or without the aid of the printed opinion of the Circuit Court of Appeals, we are convinced, that nothing was ever determined between the parties, save that under the facts and circumstances found by the Circuit Court, a bill in equity would not, as a matter of law, lie for the specific performance of the contract . . . Indisputably, these are the grounds upon which the decree of the Circuit Court of the District of Montana was reversed, and such reversal does not, therefore, embody an adjudication of the facts of the cause."

B.

The Complaint in the Instant Suit Is Different From and Supplies the Allegations the District Court Found Missing in No. 1300 on the Basis of Which It Had Rendered Its Order of Dismissal in That Case.

The rule is thus stated in Restatement of Judgments, Section 54:

"Where a judgment is rendered for the defendant on the ground of the non-existence of some fact essential to the plaintiff's cause of action, the plaintiff is not precluded from maintaining an action after such fact has subsequently come into existence."

Under Comment (a), *Rationale*, the Restatement says (pp. 211-212):

“The principle that where a fair opportunity has been afforded to the parties to litigate a claim, and the court has finally decided the controversy, the interests of the state and of the parties require that the validity of the claim shall not be again litigated by them, is not applicable to the situation stated in this Section. Where a judgment in favor of the defendant is rendered on the ground that the plaintiff’s action is prematurely brought, the plaintiff is not precluded from maintaining an action after the claim has matured. A determination by the court that the plaintiff had no enforceable cause of action at the time when the action was brought is not a determination that he may not have an enforceable cause of action thereafter, and does not preclude him from maintaining an action when his cause of action has become enforceable.”

Under Comment (c), it is stated (p. 213):

“The rule stated in this Section is applicable where the liability of the defendant is conditioned upon the happening of some event. In such a case if the plaintiff brings an action before the event has occurred, and judgment is given for the defendant on that ground, the plaintiff is not precluded from maintaining an action after the event has occurred”

And, finally, under Comment (f) it is said (p. 216):

“The rule stated in this Section is applicable although the court in the first action was in error in

dismissing the action on the ground that it was prematurely brought.”⁹

It is submitted that the instant case comes within the Restatement rule.

Thus the Court dismissed No. 1300 “because at the time the instant suit was filed the petitioner had not actually been denied a passport or other right or privilege as a national of the United States” [R. 15-16]. This was the same ground upon which the Court ruled (Appx. A, p. 2) on defendant’s first motion to dismiss [R. 6-7], the said motion being posited on the ground that no determination having been made by the Consulate, “this is fatal to Plaintiff’s cause of action because a prerequisite to a suit under 8 U. S. C. 903 is that the Plaintiff be denied ‘a right or privilege as a national of the United States . . . upon the ground that he is not a national of the United States.’ ”¹⁰

⁹See also Restatement of Judgments, Sec. 67:

“Where in an action the Court holds that the plaintiff cannot enforce a particular claim in that action on the ground that he can enforce it only in a separate action, the judgment does not preclude the plaintiff from enforcing the claim in another action, although in the second action it appears that the holding of the court in the first action was erroneous.”

Under Comment (a) of this section, it is stated (p. 287):

“It is immaterial that the plaintiff did not appeal from the ruling of the court in the first action. Where the plaintiff is defeated in the first action by an erroneous ruling on the merits of his claim and he takes no further steps in the action to have the judgment reversed, he is bound by the judgment, and cannot maintain a second action to enforce his claim. . . . The situation is different, however, where the ruling is based not on a denial of his claim . . . but only upon his right to recover in the particular action.”

¹⁰The quotation is from defendant’s Memorandum of Points and Authorities filed in support of the motion.

As noted, on the court's first ruling, defendant's theory was followed, the court holding (Appx. A, p. 2):

"Nothing in the amended complaint definitely shows that plaintiff had been denied a right or privilege as a national of the United States prior to December 23, 1952, the date the action was instituted."

Thereafter plaintiff filed an Amended and Supplemental Complaint [R. 11-12]. Defendant filed [R. 13] a Motion to Dismiss this Amended Complaint. The grounds for this Motion, as stated by defendant [R. 13], were "that the Amended and Supplemental Complaint fails to cure the defects contained in the previous Complaint, which defects were found by Judge Wiig to justify granting defendant's motion to dismiss." Or stated another way that plaintiff had prematurely brought his suit.

However, the instant case was brought and filed after there had been a denial and the complaint so alleges [R. 26-30]. The case, therefore, comes within the rule stated by the Restatement of Judgments, Section 54 (*supra*, p. 22).

In the Amended and Supplemental Complaint in No. 1300 [R. 11-12] plaintiff alleged matters, supplemented to the date he filed his suit, which were allegations of fact showing a denial. But *the court struck these allegations*, not because a complaint containing such allegations would not state a claim upon which relief could be granted but because the allegations "were not amenda-

tory matter which the Court had allowed or anticipated allowing in the leave to file an amended complaint.”¹¹

Thus it must be held that the order of dismissal was based upon the complaint *then* before the court and which, in the court’s view, showed that as of the date of filing, there had been no denial. This was a ruling, therefore, that the suit had been prematurely filed.

The court did not discuss and did not rule [R. 15-16] upon whether a suit filed after there had been a denial would state a claim upon which relief could be granted nor did it rule upon or discuss the effect of the Savings Clause (Sec. 405(a)) of the Nationality Act of 1952.

The case, therefore, comes even within the language in *Ripperger v. A. C. Allyn & Co.*, 37 Fed. Supp. 373, 374 (S. D. N. Y., 1940):

“ . . . (N)or will in (a dismissal on the ground of lack of jurisdiction) bar a second suit where the pleader in the prior suit failed to allege essential jurisdictional facts which alter his plea in a new pleading.”

Plaintiff did precisely that in the present suit. He alleged the jurisdictional facts which the court found lacking in the first suit. It must be remembered that the Court in its order of dismissal of September 23, 1954 [R. 15-16] did *not* rule that a complaint which alleged

¹¹Cf. *Williams v. Minn. Mining & Mfg. Co.*, 14 F. R. D. 1, 9 (S. D. Cal., 1953): “The same rule (not a bar to a second suit) applies for like reasons to orders made *prior* to a determination of lack of jurisdiction.” The court’s striking the supplementary allegations *before* it held no claim was stated, comes within this rule.

an application for registration before the American Consulate on October 29, 1952, an execution of a Certificate of Loss on December 29, 1952, and approval of same by the State Department in Washington on July 23, 1953, did not state a claim upon which relief can be granted. The *only* thing the court's order of dismissal of September 23, 1954 [R. 15-16] held was that a complaint which alleged that plaintiff applied to be registered as a citizen before the American Consulate on October 29, 1952, and that said Consular officials did not register plaintiff as a citizen of the United States on the day he applied therefor, did not state a claim upon which relief could be granted. That was the effect of the Court's ruling and no more. And since the missing allegations have now been supplied, the order of dismissal is no bar. It will be remembered that it was not until *after* the Court ordered stricken the allegations subsequent to December 23, 1952, that it dismissed the complaint [R. 16].¹²

Mack v. United States, 29 Fed. Supp. 65 (D. C. E. D. S. Car., 1939), is a case of interest here. The action was on a War Risk Insurance Policy. In the first case, trial of the case was reached and the Court dismissed it by the following order (p. 66):

"It appearing that suit was filed in this case before the plaintiff had secured a *denial* of her claim by the Veterans Administration; and that this court is therefore without jurisdiction to hear and determine plaintiff's alleged cause of action.

¹²See quotation from *Williams v. Minn. Mining & Mfg. Co.*, 14 F. R. D. 1, 9 (S. D. Cal., 1953), *supra*, note 11.

“It is therefore ordered that the complaint herein be dismissed.” (Italics added.)

The second suit was on the same claim *after* there had been a denial of plaintiff’s claim. The bar of *res judicata* was interposed. Ruling against the Government’s contention, the court said (29 Fed. Supp. at 67, 68):

“. . . The dismissal in this case, under the order above quoted, was because the Court had no jurisdiction to hear and determine plaintiff’s case, *the suit having been filed prior to the date of the disagreement.* (Italics added.)

“By the great weight of authority in both the State and Federal Courts a dismissal on jurisdictional grounds does not deprive the plaintiff of bringing another action . . .

“From the foregoing cases, and many others which have been carefully considered, the court concludes that a dismissal for lack of jurisdiction, such as non-existence of a disagreement is a dismissal ‘not affecting the merits.’ In the present case I am satisfied that the dismissal of the original suit did not go to the merits.”

This Court’s decision in *Johnson v. United States*, 68 F. 2d 588 (C. C. A. 9, 1934), was relied upon in the *Mack* case.

Accordingly, the first case (No. 1300) having been dismissed on jurisdictional grounds because filed prematurely, it is no bar to this suit.

C.

A Suit for a Judgment Declaring One to Be a Citizen, Where a Previous Suit Filed Before the 1952 Act Was Dismissed for Lack of Jurisdiction, Can Be Filed and Maintained After the 1952 Act Went Into Effect, the Previous Suit Not Being Res Judicata.

The authority for this proposition is *Brownell v. We Shung*, 352 U. S. 180. In 1949 the Board of Immigration Appeals ruled that plaintiff was not a citizen of the United States.¹³ We Shung sought judicial review of this order by means of a suit for declaratory relief filed *before* the effective date of the 1952 Act. The lower courts denied relief on the *merits* (103 Fed. Supp. 507, 207 F. 2d 132). The Supreme Court vacated the judgment and remanded with instructions to dismiss for lack of jurisdiction on the theory that only habeas corpus was available (346 U. S. 906). After the passage of the 1952 Act, We Shung again sought judicial review by way of declaratory judgment and the court held he was entitled thereto.

We think the *We Shung* case requires a ruling in plaintiff's favor herein. It will be noted that plaintiff in *We Shung* filed precisely the same action the second time and asked for precisely the same relief. The same, identical 1949 order of the Board of Immigration Appeals was sought to be reviewed in the same manner in the second case as in the first. The court did not permit

¹³The issue rose by way of We Shung seeking admission to the United States as the son of an American citizen.

the ruling on the first case to be a bar to the second. This is especially important and significant in view of the Government's argument in its brief in the case. Thus the Government argued (Br. p. 45):

"The issue of respondent's right to bring a declaratory judgment was in effect adjudicated against him in the prior proceedings before this court."

As seen, the Supreme Court rejected this argument. It is true that the Supreme Court in its opinion said (352 U. S. at 181): "We conclude that either remedy (habeas corpus or declaratory judgment) is available in seeking review of such orders. This makes it unnecessary for us to pass upon other questions raised by the parties." However, as seen, the Government in effect raised the issue of *res judicata* and, had it had merit, it is to be assumed the Supreme Court would have so held and disposed of the case on that ground.¹⁴

Conclusion.

The judgment should be reversed. At the minimum, the judgment should be modified so as to make clear that the judgment is not on the merits of the question as to whether plaintiff lost his United States citizenship by reason of his Japanese Military Service or voting.¹⁵

¹⁴In its Petition for Writ of Certiorari in the *We Shung* case, p. 5, the Government said that though the Court of Appeals had ruled the prior case *not res judicata*, it was not contesting the point here. But, as seen, it did in its Brief, after certiorari was granted, in effect raise the matter again. And if it did not contest the point, the concession is of even greater force.

¹⁵If this minimum relief is granted, it will at least enable plaintiff to pursue 8 U. S. C. 1503(b) and (c).

Otherwise plaintiff will have been adjudged expatriated without ever having had a day in court and without the Government having even attempted to carry the burden of proof required of it in expatriation cases (*Nishikawa v. Dulles*, 356 U. S., 2 L. Ed. 2d 659).

Respectfully submitted,

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APPENDIX "A".

In the United States District Court for the District of Hawaii.

Yoichi Fujii, Plaintiff, v. John Foster Dulles, Secretary of State of the United States of America and the United States Department of State, Defendants. Civil No. 1300.

Ruling on Motion to Amend and Motion to Dismiss Complaint.

Plaintiff filed this action under Section 503 of the Nationality Act of 1940, 8 USCA Section 903, on December 23, 1952. His complaint seeks a judgment declaring him to be a national of the United States of America. On December 2, 1953, plaintiff filed a motion for leave to file an amended complaint. However, in the interim, defendant had filed a motion to dismiss the complaint. Rule 15(a) of the Federal Rules of Civil Procedure, 28 USCA, provides in part:

"A party may amend his pleadings once as a matter of course at any time before a responsive pleading is served * * *."

A motion to dismiss is not a "responsive pleading" within the meaning of Rule 15(a). *United States v. Newbury Mfg. Co.*, 123 F. 2d 453, 454 (1 Cir. 1941); *Kelly v. Delaware River Joint Commission*, 187 F. 2d 93, 94 (3 Cir. 1951), cert. denied 342 U. S. 812 (1951). Apparently, this is plaintiff's first attempt to amend his complaint. Therefore, under Rule 15(a), the motion for leave to file an amended complaint must be granted as a matter of course. *Whittemore v. Continental Mills*, 98 F. Supp. 387 (D. Me. 1951).

Defendant's motion to dismiss the complaint is based on the ground that it fails to state a claim upon which

relief can be granted. Rule 12(b)(6), Federal Rules of Civil Procedure. A close scrutiny of the complaint, as amended, justifies the granting of the motion to dismiss.

Section 503 of the Nationality Act of 1940, 8 USCA Section 903, conferred restricted jurisdiction on this Court. To state a Section 503 claim, the complaint must allege that the alleged national was denied a right or privilege as a national by a governmental department or agency, or an executive official thereof, upon the ground that he is not a national of the United States. See *Dulles v. Lee Gnan Lung*, No. 13,695 (9 Cir., March 30, 1954). Inasmuch as Section 503 was repealed as of December 24, 1952, the complaint must clearly allege that such denial of a right or privilege had occurred prior to that date. See *Suga v. Dulles*, No. 1313 (D. Hawaii, January 27, 1954).

Paragraph IV of the amended complaint is devoid of any date. It is alleged that "quite some time before the filing of this suit," the plaintiff sought to secure a passport from the American Consulate in Tokyo, Japan; that the plaintiff was issued a "Certificate of the Loss of Nationality of the United States"; and that the refusal to issue plaintiff a passport is a denial of plaintiff's rights and privileges as a United States citizen. Nothing in the amended complaint definitively shows that plaintiff had been denied a right or privilege as a national of the United States prior to December 23, 1952, the date the action was instituted.¹ Without such allegation in the

¹Footnote 1 of plaintiff's memorandum in support of motion for leave to file amended complaint indicates that the Department of State approved the issuance of a Certificate of the Loss of Nationality of the United States on July 23, 1953. However, such fact outside the pleadings was not considered in ruling on the motion to dismiss.

amended complaint, no claim is stated within the meaning of Section 503 of the Nationality Act of 1940.

The state of the amended complaint and the reasoning for this ruling do not require any discussion of the savings clause, Section 405 of the Immigration and Nationality Act (1952), 8 USCA Section 1101 note.

For the reasons stated above, defendant's motion to dismiss the amended complaint is granted. Plaintiff will have thirty days from the date of the filing of this ruling to amend the complaint if he can plead facts which will state a claim upon which relief can be granted.

Dated at San Diego, California, this 26 day of May, 1954.

JON WIIG (Stated)

Jon Wiig

United States District Judge.

No. 15,902

IN THE

United States Court of Appeals
For the Ninth Circuit

YOICHI FUJII,

Appellant,

vs.

JOHN FOSTER DULLES, Secretary of
State of the United States,

Appellee.

On Appeal from the United States District Court
for the District of Hawaii
in Civil No. 1487.

APPELLEE'S ANSWERING BRIEF.

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PAUL P. O'BRIEN, CL

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No. 15,902

IN THE
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YOICHI FUJII,

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State of the United States,

Appellee.

On Appeal from the United States District Court
for the District of Hawaii
in Civil No. 1487.

APPELLEE'S ANSWERING BRIEF.

Appellee agrees with Appellant's statement of pleadings and facts disclosing jurisdiction but adds the following as they relate to the motion to dismiss. The District Court had jurisdiction to decide jurisdiction.

STATEMENT OF THE CASE.

The Appellee agrees with Appellant's statement of the case as it relates to the motion for summary judgment with the reservation that Appellee agrees

with the facts stated but not with the argumentative statements found in the last paragraph of page 4 of Appellant's Brief beginning, "In other words . . ." and running to the end of the paragraph. As to the motion to dismiss the Appellee agrees with Appellant's statement of the case, except for the allegations that the District Court had jurisdiction (Br. 3).

QUESTIONS PRESENTED.

1. Did the District Court have jurisdiction in Civil No. 1487?

2. Is the granting of a motion to dismiss for failure to state a claim *res judicata* of a subsequent suit between the same parties under the same law and concerning the same facts?

I. THE DISTRICT COURT DID NOT HAVE JURISDICTION TO HEAR AND DETERMINE A CLAIM FOR RELIEF UNDER 8 U.S.C. §903 AT THE TIME THE COMPLAINT WAS FILED.

This Court should examine into its jurisdiction whether such point has been raised or not.

Sutherland v. American Equitable Assurance Co. of New York, (2 Cir. 1930), 43 F. (2d) 973;

Cory Bros. & Co. v. U. S., (2 Cir. 1931), 47 F. (2d) 607;

U. S. v. King & Howe, (2 Cir. 1935), 78 F. (2d) 693;

Osburn v. U. S., (4 Cir. 1931), 50 F. (2d) 712, 713;

In Re Perlman, (7 Cir. 1934), 68 F. (2d) 729.

The Court of Appeals should satisfy itself not only of its own jurisdiction but also of that of the District Court in this claim for relief.

Mitchell v. Maurer, 293 U.S. 237, 244, 55 S.Ct. 162, 79 L.Ed. 338 (1934).

The question of jurisdiction was raised in the District Court by the motion to dismiss (R. 33-34). The District Court passed on this question by denying the motion to dismiss (see Supplemental Transcript of Record), although this is somewhat beclouded by the District Court's ruling on motion for summary judgment (R. 39).

The complaint herein was filed June 6, 1956 (R. 32). This was almost three and one-half years after the repeal of the Nationality Act of 1940 on December 24, 1952 (Immigration and Nationality Act, § 403(a) (42)). It was also some twenty months after the order of dismissal was filed in Civil No. 1300 (R. 15-16).

The Appellant in this action contends that the District Court has jurisdiction under the Nationality Act of 1940, 8 U.S.C. § 903, and § 405(a) of the Immigration and Nationality Act of 1952 (note to 8 U.S.C. § 1101). It is the contention of the Appellee that the District Court does not have jurisdiction to hear and determine the issues raised herein for the following reasons:

1. What the Appellant claims is saved by the savings clause is a procedural remedy and not a substantive right. If it is a procedural remedy, it is not saved by the savings clause.

Aure v. U. S., (9 Cir. 1955), 225 F. (2d) 88;

Hallowell v. Commons, 239 U.S. 506;

De La Rama Steamship Co. v. U. S., 344 U.S. 386;

Aiko Matsuo v. Dulles, 133 F. Supp. 711.

The question then to be determined is whether § 503 is a statute which sets up a right, or is one which sets up a procedural remedy. The Appellee contends that it sets up a procedural remedy. The above provision of the Nationality Act of 1940 was repealed effective December 24, 1952, by § 403(a)(42) of the 1952 Act. This complaint was filed June 6, 1956 under that repealed statute. The Appellant cannot complain that without § 503 he would be without any remedy. He must complain then that without § 503 he would not have the full judicial remedy in the District of Hawaii. § 403(a)(42) of the Immigration and Nationality Act, together with the other provisions thereof does not take away any substantive right because it simply changes the tribunal that is to hear the Appellant's particular case. This is true even though the change of tribunals is from a judicial tribunal to an administrative one.

Hallowell v. Commons, 239 U.S. 506;

Matsuo v. Dulles, 133 F. Supp. 711.

When Congress repealed § 503 it created new and different remedies, applicable to Appellant's situation.

What was then lost to Appellant under the repeal of § 503 was not a substantive right.

Further, this statute is not like that in *De La Rama Steamship Co. v. U. S.*, 344 U.S. 386. In that case, the statute had a dual nature, in that it included both the substantive rights, i.e., the right to recover under the War Risk Insurance Act of 1940, and the tribunal in which the case could be tried, i.e., in the District Court. In that case the procedural remedy and substantive rights are fused components of an expression of policy. Where Congress intends to take away jurisdiction, the remedy does not survive even as to pending suits unless expressly reserved.

Ex Parte McCardle, 7 Wallace 506;

Hallowell v. Commons, *supra*;

Bruner v. U. S., 343 U.S. 112.

See also *Lew Hsiang et al. v. Brownell*, (7 Cir. 1956), 234 F. (2d) 232, in which the Court in effect stated that the plaintiffs had not previously been denied rights or privileges as United States citizens prior to the expiration of the Nationality Act of 1940, and that this jurisdictional defect tainted the proceeding. Without a jurisdictional anchor in 1952, their complaint was held unavailing as a remedy, then or now.

A similar conclusion was reached in *Young Jin Teung v. Dulles*, (2 Cir. 1956), 229 F. (2d) 244.

The appellant contends that the jurisdictional issue herein has been settled in this Court by *Junso Fujii v. Dulles*, 224 F. (2d) 906 (1955), stating "where the factual situation before the Consulate was identical

with that here.” (Br. 9). One vital problem has been overlooked by Appellant. The complaint herein was filed on June 6, 1956 (R. 32), after the expiration of the Nationality Act of 1940. Further, the facts before the Consulate were not the same as the District Court found after trial on the merits. “In October, 1952, plaintiff [Junso Fujii] applied at the American Consulate in Kobe, Japan, for a passport to return to the United States as a citizen thereof. Said application was denied and instead plaintiff was issued a Certificate of the Loss of Nationality of the United States on December 18, 1952, on the ground that he has lost his United States Citizenship under 8 U.S.C. 801(c), by reason of the above set forth military service.” (Findings of Fact, April 13, 1956, *Junso Fujii v. Dulles*, Civil 1261, U.S.D.C. Hawaii (unreported)).

The *Fujii* case cannot be said to be on all fours with the case herein. The essential point made in the *Junso Fujii* case is as follows: “Insofar as the supplemental pleading alleges matters subsequent to the ‘pleading sought to be supplemented’ it should be considered as is an amendment and allowable as such under FRCP 15(c).” *Junso Fujii v. Dulles*, 224 F. (2d) 906, 907. The only question then was for the Court to consider whether § 405(a), Immigration and Nationality Act (66 Stat. 166, et seq.) continued the action pending at its effective date. The question here is whether § 503 of the Nationality Act survives for three and one-half years after its repeal to be used by one who did not exercise this procedural remedy during its lifetime. Or, more accurately, by

one who used it but did not follow through on appeal on a contested issue and is now attempting *to use it again three and one-half years after its repeal.*

II. THE DECISION IN CIVIL NO. 1300 GRANTING THE MOTION TO DISMISS FOR FAILURE TO STATE A CLAIM IS RES JUDICATA AS TO THIS PRESENT SUIT.

There is no doubt that as to this individual Appellant, the ruling of the District Court was harsh. But the ruling of the District Court was no harsher than its ruling in Civil No. 1300 denying motion by Appellant to set aside the order of dismissal filed therein (R. 32). As a matter of fact, an appeal was perfected from that order (R. 48) and was subsequently dismissed in this Court by stipulation (see *Yoichi Fujii v. Dulles*, No. 15,259). In this connection, that is, as to the harshness of the rule, this Court is referred to *Ackermann v. U. S.*, 340 U.S. 193, in which the Supreme Court states at page 198, "There must be an end to litigation someday, and free, calculated, deliberate choices are not to be relieved from." If Appellee and the District Court are correct, then no amount of *a priori* reasoning will change Appellant's predicament.

A. The Order of the District Court in Civil No. 1300 (R. 15-17) Is a Dismissal for Failure to State a Claim.

The District Court's orders and rulings plainly say that the decisions made on May 26, 1954 (Br. Appendix A) and September 23, 1954 (R. 15-17) are for failure to state a claim. The record further shows that

counsel for Appellant had no objection as to the form of the order entered (R. 17).

The District Court decided that there had not been alleged an essential element in the complaint. Once the Court decided this, then obviously the Court was deciding that Appellant had failed to state a claim. Appellant's argument seems to say, the Court said this but didn't really mean it. Therefore, we can look to substance to decide whether its decision rested on jurisdictional grounds—citing *Young v. Higbee Co.*, 324 U.S. 204, 209, which stands for the age old principle that equity looks to substance rather than to form. *Mullen v. Fitz Simons, etc.*, (7 Cir. 1948), 172 F. (2d) 601, 602, which holds that where a Court dismisses for failure to state a claim, then it must be assumed that Appellees' theory of the case has been followed. The Court there being aware of Appellees' theory notes it was not based on failure to state a claim.

B. A Decision for Failure to State a Claim if Sustained Without Leave to Plead Further Results in a Judgment on the Merits.

From the facts, the dismissal in Civil No. 1300 was a dismissal for failure to state a claim. Rule 41(b) provides that this type of dismissal "operates as an adjudication upon the merits." See 2 Barron and Holtzoff, § 917. Further, a motion to dismiss for failure to state a claim raises the matter in bar and, if sustained without leave to plead further, results in a judgment on the merits. *Mullen v. Fitz Simons and Connell Dredge and Dock Co.*, (7 Cir. 1948), 172 F.

(2d) 601; *Sardo v. McGrath*, (D.C. Cir. 1952), 196 F. (2d) 20; and *Broder v. Hartford Accident & Indemnity Co.*, (D.C. D.C.), 17 Federal Rules Service, 12(b) 35, case 2. See also 1 Barron and Holtzoff, § 356, pages 642, 643.

Consequently, if there is a final judgment, as there is in Civil No. 1300, on a motion to dismiss for failure to state a claim, then it is an adjudication on the merits, unless otherwise so specified. Rule 41(b); *Mullen v. Fitz Simons and Connell Dredge and Dock Co.*, *supra*; *Sardo v. McGrath*, *supra*; and *Billings Utility Co. v. Advisory Committee Board of Governors*, (8 Cir. 1943), 135 F. (2d) 108.

The above quoted *Billings Utility Company* case is as near to being on all fours with this case as any that have been cited to the Court. There, the main difference was that there were two different United States District Courts involved, but in the prior case the case was dismissed for failure to state a claim; and the Court held that this was a decision on the merits and *res judicata* would apply to a second suit filed between their parties or privies. The Court also stated that the usual rule as to *res judicata* applies in that not only what was litigated but what could have been litigated was foreclosed from being retried. *Billings Utility Co. v. Advisory Committee Board of Governors*, *supra*; *Western Pacific Railroad Corp. v. Western Pacific Railroad Co.*, (9 Cir.) 216 F. (2d) 513; *Hatchitt v. U. S.*, (9 Cir.), 158 F. (2d) 754; *Chicot County Drainage Dist. v. Barter State Bank*, 308 U.S. 371; *C.I.R. v. Sunnen*, 333 U.S. 591.

In connection with whether a dismissal for failure to state a claim upon motion to dismiss is *res judicata*, the reasoning and authorities cited by the District Court are very helpful (R. 39-40).

“Rule 41(b) of the Federal Rules of Civil Procedure cannot be strictly applied at or after trials, but in this case must be read conjunctively with Rule 12(b)(6). The Court is aware that a motion to dismiss cannot be substituted for a trial on the merits, 1 Federal Practice and Procedure (Barron and Holtzoff) 608, § 349 n. 79, but such is not our concern. ‘This motion [to dismiss] has been declared on the one hand to be essentially the same as a demurrer. . . .’ 1 Federal Practice and Procedure (Barron and Holtzoff) 603, § 348, n. 65; ‘. . . [and] performs the function formerly performed by a demurrer.’ *Flanigan v. Security-First National Bank*, D.C. S.D. Cal. 1941, 41 F. Supp. 77, 79. ‘A decree entered upon demurrer is no less effective as *res judicata* than a decree rendered upon proof.’ *Sacks v. Stecker*, 62 F. (2d) 65, 66; *Old Dominion Copper Mining and Smelting Co. v. Lewisohn*, 202 F. 178; *Northern Pacific Ry. v. Slight*, 202 U.S. 122, 27 S. Ct. 442, 51 L. Ed. 738, 106 A.L.R. 437; *W. E. Hedger Transp. Corporation v. Ira S. Bushey & Sons, Inc.*, E.D. N.Y. 1950, 92 F. Supp., 112, affirmed 186 F. (2d) 236.”

C. A Decision on a Motitn to Dismiss for Failure to State a Claim May Result in a Judgment on the Merits.

As the District Court noted Rule 41(b) and Rule 12(b)(6) should be considered together. “*For failure of the plaintiff . . . to comply with these rules . . . a defendant may move for dismissal of any action*

against him . . . unless the Court in its order for dismissal otherwise specifies, a dismissal under this subdivision and any dismissal not provided for in this rule, other than a dismissal for lack of jurisdiction or for improper venue, operates as an adjudication on the merits.” (Rule 41(b) FRCP in part).

“The dismissal of an action for failure to state a claim upon which relief can be granted usually results in a judgment on the merits.” (1 Barron and Holtzoff, § 356, pages 642-643), citing *Mullen v. Fitz Simons and Connell Dredge and Dock Co.* (7 Cir. 1948), *supra*.

There is no restrictive limitation on the Court’s order of dismissal in Civil No. 1300 (R. 15-17).

III. THE ORDER OF DISMISSAL IN CIVIL NO. 1300 IS A JUDGMENT ON THE MERITS AND AS SUCH IS RES JUDICATA.

It cannot be seriously contended that a dismissal for lack of jurisdiction is *res judicata* of a subsequent suit unless it falls within the special category of cases discussed in *Ripperger v. A. C. Allyn & Co.*, 37 F. Supp. 373, 374 (S.D. N.Y. 1940).

However, as discussed *supra* the decision in Civil No. 1300 is a judgment on the merits.

But an examination of the amended and supplemental complaint in Civil No. 1300 (R. 11-12) and of the complaint herein (R. 26-30), shows very little difference in the allegations except that those herein are alleged in more detail.

Appellee
 The ~~Appellant~~ contends that there are no extra or additional jurisdiction elements in this complaint (R. 26-30) than found in the amended and supplemental complaint in Civil No. 1300 (R. 11-12).

Ripperger v. A. C. Allyn & Co., (S.D. N.Y. 1940), 37 F. Supp. 373, 374, affirmed (2 Cir. 1940), 113 F. (2d) 332, 333, cert. denied 1941, 311 U.S. 695, 61 S. Ct. 136, stands for the very simple and understandable fact that a decision on jurisdiction is *res judicata* on a second suit based on the same jurisdictional facts. As is the case here. It is sound and compelling authority in favor of the Appellee. For the purpose of this argument, the order of dismissal in Civil No. 1300 is considered to be for lack of jurisdiction.

An Analysis of *Brownell v. We Shung*, 352 U.S. 180.

Again a vital issue was omitted in the discussion of the case by Appellant (Br. 29-30). The important issue was the jurisdictional effect of *different* immigration laws on a suit for review under the administrative procedures act, 60 Stat. 237, 5 U.S.C. § 1001, et seq.

The Court held that only under the Immigration and Nationality Act of 1952, this method of review was permissible. Under prior immigration law it had not been. *Heikkila v. Barber* (1953), 345 U.S. 229.

CONCLUSION.

The District Court was correct in holding that the former dismissal in Civil No. 1300 was *res judicata* upon this suit. It was incorrect in holding that it had jurisdiction to hear and determine this claim for relief (Supp. Transcript). In this connection, the judgment of the District Court should be modified to order dismissal for lack of jurisdiction. This will wipe out the ruling that the decision in Civil No. 1300 is *res judicata* and may in some measure allow what Appellant asks in footnote 15 (Br. 30).

Dated, Honolulu, T. H., this 10th day of June, 1958.

Respectfully submitted,

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No. 15902
IN THE
United States Court of Appeals
FOR THE NINTH CIRCUIT

YOICHI FUJII,

Appellant,

vs.

JOHN FOSTER DULLES, Secretary of State of the United
States,

Appellee.

Appeal From the United States District Court for the
District of Hawaii.

APPELLANT'S REPLY BRIEF.

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IN THE
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vs.

JOHN FOSTER DULLES, Secretary of State of the United
States,

Appellee.

Appeal From the United States District Court for the
District of Hawaii.

APPELLANT'S REPLY BRIEF.

I.

The District Court Had Jurisdiction Over No. 1487.
(Reply to Appellee's Point I, pp. 2-7.)

Appellee contends that this court's decision in *Junso Fujii v. Dulles*, 224 F. 2d 906, does not stand for the proposition of law that where the application for passport was filed before the effective date of the 1952 Act but was not denied until after the effective date, the savings clause of the 1952 Act permits the filing of suit thereafter and thus gives the District Court jurisdiction. Appellant contends that it does. A reading of the *Junso Fujii* case can permit of no other conclusion. What appellee is really saying is that *Lew Hsiang v. Brownell*, 234 F. 2d 232 (C. A. 7, 1956), and the dictum in *Young Jin Teung v. Dulles*, 229 F. 2d 244 (C. A. 2, 1956) (both cited by

Appellee, Br. p. 5) represent the correct law and that this court's decision in *Junso Fujii* is incorrect.¹

One answer to this contention is, of course, that the *Junso Fujii* case is the law in this circuit as expressed by this Court. But an even better answer is that *Junso Fujii* correctly interprets the law and carries out both the intent and the language of the savings clause.

It is true that the *Junso Fujii* complaint was filed before the effective date of the 1952 Act, but this Court said (224 F. 2d at 907) there was jurisdiction in the trial court even if the actual denial did not occur until March 18, 1953, a date after the effective date of the Act. If, as this Court recognized, the administrative proceedings had to be completely finished before the effective date of the 1952 Act, it would set at naught the savings clause which preserved "rights in process of acquisition." Thus to construe the clause would be not only to ignore its plain language and meaning but would contradict the Supreme Court's holding in *United States v. Menasche*, 348 U. S. 528. In that case the Supreme Court said (348 U. S. at 535):

" . . . The change in the section was designed to extend a savings clause already broadly drawn, and embodies, we believe, congressional acceptance of the principle that the statutory status quo was to continue *even as to rights not fully matured*. . . ." (Italics added.)

¹The dictum in *Young Jin Teung* says as much. Appellee's citation of the *Lew Hsiang* case is significant, however, because it recognizes that the conception (albeit, as we say, erroneous) that there must be a final administrative denial before the December 24, 1952 date has reference to the *jurisdiction* of the trial court. If this be so, then, although Appellee refuses to recognize it, a dismissal (as in No. 1300) for lack of finality, cannot be on the merits.

The principle of the *Junso Fujii* case, (application filed before the effective date but not acted upon or completed until after) has been applied in a number of different situations. The *Menasche* case is one. There the declaration of intention was filed before the effective date, but the actual petition for naturalization was filed after.

Other cases are:

Petition of Pringle, 212 F. 2d 787 (C. A. 4, 1954)
(same as *Menasche*);

Yanish v. Barker, 211 F. 2d 467 (C. A. 9, 1954)
(rights re bond fixed as of date of deportation proceedings filed before the effective date);

United States ex rel. Zacharias v. Shaughnessy, 221 F. 2d 578 (C. A. 2, 1955) (preliminary application for immigration visa filed before the effective date; not acted upon until after);

In re Carnavus, 155 Fed. Supp. 12 (S. D. N. Y., 1957) (preliminary application for naturalization filed before effective date; petition filed after).

Accordingly the fact that the complaint in the case at bar was not filed until after the effective date is of no significance. Certainly this is true where there is no problem as to the final denial being before the effective date of the 1952 Act. Where this occurs, the right to file suit, and the jurisdiction of the District Court to entertain it is clear. This was so held by the Court of Appeals for the District of Columbia in *Wong Kay Suey v. Brownell*, 227 F. 2d 41 (1955), and in *Dulles v. Richter*, 246 F. 2d 709 (1957). This rule has been accepted and followed by this Court in *Garcia v. Brownell*, 236 F. 2d

356 (1956). Citing the *Wong Kay Suey* case, this Court said (236 F. 2d at 357):

“ . . . (I)t has been judicially declared that where one was excluded from admission to the United States prior to the repeal of Section 503 of the Nationality Act of 1940, his right to have his citizenship determined was preserved by the savings clause contained in the Immigration and Nationality Act of 1952”²

To the same effect are *Frausto v. Brownell*, 140 Fed. Supp. 660 (S. D. Cal. 1956), and *Moy Yee Mon v. Dulles*, 161 Fed. Supp. 924 (E. D. Mich. 1956).

In the light of these cases, embarking up the alley of substantive versus procedural, as appellee would have us do (Br. 4), would not be helpful. In the first place, it is by no means clear that Congress intended any such restrictive interpretation of its very broad language (*cf.* the Supreme Court in *Menasche*), nor is it clear that the right asserted here is merely procedural. Appellant contends, if need be, that the right is substantive. The court in the *Moy Yee Mon* case so held. (161 Fed. Supp. 924, 929.)

Accordingly, the trial court had jurisdiction herein and properly decided that it did. [Supp. Rec.]

²Following this court's decision in the *Garcia* case, the writer of the dictum in *Aure v. United States* (C. A. 9, 1955), 225 F. 2d 88, and the decision in *Matsuo v. Dulles*, 133 Fed. Supp. 711, ruled that the *Wong Kay Suey* rule was the law of this Circuit. (*Kurusomi v. Dulles*, No. 20239, S. D. Cal. Oct. 15, 1956—unreported.)

II.

The Order of the Trial Court Dismissing No. 1300
Is Not Res Judicata. (Reply to Point II, pp. 7-12.)

Appellee engages in fruitless semantics when he says (Br. 7-8) that the dismissal in No. 1300 was for failure to state a claim. It is plain for everyone to see that the basis for the No. 1300 dismissal was for believed lack of jurisdiction. One need not wonder or guess at the basis of the court's ruling.³

In the order dismissing No. 1300, the court said that [R. 15, 16]

“plaintiff has failed to state a claim or cause of action against the defendant upon which relief can be granted, *because at the time the instant suit was filed the petitioner had not actually been denied a passport or other right or privilege as a national of the United States;*” (Italics added.)

This is clearly a ruling on the face of the order for lack of jurisdiction.

But we need not stop with the order itself. In ascertaining the meaning of the order of dismissal this court is entitled to look at the opinion of the trial court.⁴ As

³*Mullen v. FitzSimons, etc.*, 172 F. 2d 601, 602, relied upon by appellee (Br. 8) does not support him. The court in that case was not content to look at the bare complaint and motion to dismiss, but examined the whole case to determine what was involved before the district court and what was the effect of the lower court's ruling. In so doing, the court ascertained that appellee misconceived the function of a motion to dismiss. Thus it said (172 F. 2d at 602): “Nor may the absence of common law *jurisdiction* over a contract claim in the absence of diversity of citizenship be used in support of a motion to dismiss for insufficiency.” (Italics added.) So here.

⁴In the *FitzSimons* case, *supra*, n. 3, the court ascertained the meaning of the trial court's order from the briefs of counsel.

was said in *Great Lakes Dredge & Dock Co. v. Huffman*, 319 U. S. 293, 295:

“The formal judgment ordered dismissal of the suit, but it is to be interpreted in the light of the court’s opinion, findings, and conclusions of law.”

When one examines the written opinion of the trial judge (App. Op. Br. Appx.) it is at once apparent that the dismissal was on jurisdictional grounds and jurisdictional grounds alone and that the trial court (and appellee), just as did the trial court in the *FitzSimons* case, misconceived the function of the motion to dismiss for failure to state a claim. Thus the court, after stating (App. Op. Br. Appx. 2) that “a close scrutiny of the complaint, as amended, justifies the granting of the motion to dismiss,” said (*ibid.*):

“Section 503 of the Nationality Act of 1940, 8 USCA Section 903, *conferred restricted jurisdiction* on the court. To state a Section 503 claim, the complaint must allege that the alleged national was denied a right or privilege Inasmuch as Section 503 was repealed as of December 24, 1952, the complaint must clearly allege that such denial of a right or privilege had occurred prior to that date

“. . . . Nothing in the amended complaint definitely shows that plaintiff had been denied a right or privilege as a national of the United States prior to December 23, 1952, the date of action was instituted” (*Italics added.*)

Is this not, therefore, a ruling that the complaint was being dismissed because of the “restricted jurisdiction” of the court? And is this not a dismissal because of lack of jurisdiction? We believe so and that the court’s rulings cannot be otherwise considered.

Having started with the straw man that the dismissal of No. 1300 was for failure to state a claim and not, as we urge as strongly as we can, because of supposed lack of jurisdiction, appellee then goes on to urge (Appellee Br. 8-11) that such a dismissal is on the merits. Appellee relies particularly upon *Billings Utility Co. v. Advisory Committee Board of Governors*, 135 F. 2d 108 (C. A. 8, 1943). But that case is of no utility here. The first case by the Montana court was clearly a decision on the merits, that court holding (135 F. 2d at 109) "the action should be dismissed because, under the Federal Reserve Act, as amended, the bank was under no obligation to make any loan, but the making of loans was discretionary with it." Thus clearly the Montana court went into the merits of the plaintiff's claim. The same cannot be said here. Appellee cannot contend that this Court in No. 1300 went into the question as to whether plaintiff was or was not a citizen.

So too are all the other cases cited by Appellee (Br. 9) of no assistance; the previous cases in all of them were on the merits, most of them being decrees after trial of the facts or on agreed facts.

Nor does Rule 41 (b), Rules of Civil Procedure, either with or without Rule 12 (b) (6) assist appellee. In our opening brief (pp. 14-15) we pointed out that Rule 41 (b) has to do with dismissals of litigation at a time when it had reached the "advanced stage" of trial (*Russo v. Sofia Bros.*, 2 F. R. D. 80 (D. C. May, 1941); 2 Baron & Holtz-hoff § 917, p. 635, N. 5); not on preliminary motions in advance of trial. While as to Rule 12 (b) (6), appellee's principle case, in addition to the *Billings* case which we discussed above, is *Mullen v. FitzSimons, etc. Co.*, 172 F. 2d 601 (C. A. 7 1949). But that case, as we previ-

ously pointed out is of interest not because of its dictum statement of the general rule relied upon by appellee, but because it demonstrates that courts will look to substance and not form and determine what a court actually did rather than rely upon label or fiction. In that case the motion was made on the ground of failure to state a claim and the court simply dismissed. This brought into play another rule that it is to be assumed the court dismissed for failure to state a claim. But the Seventh Circuit did not rest on this assumption and examined into the real basis of defendant's motion and, therefore, of the court's ruling. So doing, it properly ruled that the court's decision was not based upon failure to state a claim but rather upon questions concerning the right to invoke the general maritime law and the Jones Act at the same time, whether, in the absence of diversity, one can assert a common law right to maintenance and cure, whether the complaint was simple, concise and direct and whether the complaints traveled on conclusions not admitted by the motions to dismiss. Accordingly, the court said (and its remarks are applicable here) (172 F. 2d at 603):

“They (the issues presented by defendants' motions to dismiss for failure to state a claim) completely mistake the function of the motion to dismiss.”

So here, where the real basis of defendant's motion to dismiss and of the trial court's ruling in granting it, was that the District Court had no jurisdiction because of the lack of a denial prior to the date of the filing of the complaint.

III.

The Dismissal in No. 1300 Is Not Res Judicata. (Reply to Point III, pp. 11-12.)

Appellee is quite mistaken in his appraisal (Br. 11) that there is very little difference, except for mere detail, between the complaint in this case [R. 26-30] and the amended and supplemental complaint in No. 1300. [R. 11-12.] This, because appellee completely overlooks the fact that *before* ruling on the motion to dismiss in No. 1300, the court struck [R. 16] certain important and essential allegations, namely the allegations of denial of a right or privilege as a citizen or national of the United States on the ground that plaintiff is not a citizen.⁵

This is an extremely important and significant fact especially in the light of appellee's position in this, a case where "the law and the facts (should) be construed in such a manner as to avoid a loss of citizenship." (*Junso Fujii v. Dulles*, 224 F. 2d 906, 907 (C. A. 9 1955).)⁶ The complaint which the court dismissed [R. 16] in No. 1300 was not the same as the complaint in the case at bar. [R. 26-30.] The complaint, after the court had stricken

⁵The allegation stricken was to the effect that instead of approving plaintiff's application to be registered as a citizen of the United States, "on December 29, 1952, the American Vice Consul at Tokyo executed as to Plaintiff a Certificate of the Loss of the Nationality of the United States on the ground that Plaintiff had lost his United States citizenship by reason of his said service in the Japanese Armed Forces. Said Certificate was approved by the Department of State in Washington, D. C., on July 23, 1953, and sent to the Plaintiff by the said Consular Office on September 25, 1953." [R. 12.]

⁶*Cf. Builders Corp. of America v. United States* (June 6, 1958), 26 U. S. Law Week 2628 (C. A. 9):

"It is the announced position of the office of the Attorney General that cases against the government will be disposed of on the merits rather than on technical interpretations of the pleadings. . . ."

essential elements, which the court dismissed in No. 1300 was a complaint which did not contain the crucial allegations that plaintiff had been denied by defendant a right or privilege as a citizen or national of the United States on the ground that he was not a national. The complaint, as it stood when the court dismissed it was simply a complaint that alleged [R. 11-12] that plaintiff had applied at the Consular Division of the Embassy in Tokyo to be registered as a citizen of the United States and that the consular officials did not recognize him as a citizen on the day he applied. Such a complaint fails to invoke the jurisdiction of the court. (*Fletes-Mora v. Brownell*, 231 F. 2d 579 (C. A. 9, 1955); *Florentine v. Landon*, 231 F. 2d 452 (C. A. 9, 1955); *Elizarraraz v. Brownell*, 217 F. 2d 829 (C. A. 9, 1954).)

But this essential allegation *was* in the complaint in No. 1487. Accordingly the dismissal in No. 1300 cannot be *res judicata* because it was based upon an entirely different set of facts than in No. 1487. (See discussion in App. Op. Br. 25-27.)

The most, therefore, that the dismissal of No. 1300 can be *res judicata* of is that the court has no jurisdiction where there is no allegation of denial. But that is not this case, because here there is the allegation of denial.

But even if the dismissal of No. 1300 can somehow be twisted into a dismissal for lack of jurisdiction where there is the allegation of denial (an exercise in mental gymnastics which cannot be permitted), appellee's efforts (Br. 12) to distinguish *Brownell v. Tom We Shung*, 352 U. S. 180, must fail. As was pointed out in Appellant's Opening Brief (p. 30), the Government argued the *res judicata* point in *Tom We Shung* but did not convince

the Supreme Court of its validity. Had the point merit, the case would have been decided in the Government's favor for, as pointed out by the Court 352 U. S. 180 at 183), for habeas corpus to lie the alien must be in custody. The alien there was not in custody. So his only remedy was, on the facts of the case, by declaratory judgment. Since that was precisely what he had sought in the previous case, *res judicata*, if a valid argument, should apply.

The fact that the 1952 Act intervened in the *Tom We Shung* case does not serve to distinguish the case; rather does it serve to make the case more applicable here for here too the 1952 Act intervened.

Appellee's suggestion in his conclusion (p. 13) that the judgment of the District Court should be modified to order dismissal for lack of jurisdiction and the suggestion that this will allow appellant the benefits of 8 U. S. C. 1503(b) and (c), is appreciated, but it will not give appellant the protection to which he is entitled.

Appellee has since 1948 [R. 28] contested appellant's assertion of citizenship.⁷ Since February 11, 1953 [R. 6-7] appellee has interposed every technical objection possible to avoid a decision on the merits. In the case at bar, appellee took the position, and takes it now, that the dismissal in No. 1300 was on the merits and is *res judicata*. This was an affirmative defense. It did not go to the jurisdiction of the Court. It did not have to be raised and unless affirmatively raised, the defense of *res judicata* would not have been available. (Rule 8(c), Federal Rules of Civil Procedure; *United States v. One 1946 Plymouth*,

⁷A position which on the merits, if they can ever be reached, is undoubtedly unsound. (*Nishikawa v. Dulles*, 356 U. S. 129, 2 L. Ed. 2d 659.)

167 F. 2d 3, 8 (C. A. 7, 1948).) Since appellee argues so vigorously in this proceeding that the dismissal in No. 1300 was on the merits and is *res judicata*, appellant, unless the judgment of this court shows clearly to the contrary, will have no assurance that the same position will not be taken in an 8 U. S. C. 1503 proceeding. Appellant is entitled to protection in such a proceeding at the minimum.

Obviously, of course, this is not to suggest that appellant believes his arguments calling for outright reversal are not well taken. Quite the contrary is the case.

Conclusion.

The judgment should be reversed and appellant given his day in court on the merits.

Respectfully submitted,

ROY E. TAKUSHI,

A. L. WIRIN,

FRED OKRAND,

Attorneys for Plaintiff-Appellant.

No. 15902

United States
Court of Appeals
for the Ninth Circuit

YOICHI FUJII,

Appellant,

vs.

JOHN FOSTER DULLES, Secretary of State of
the United States,

Appellee.

Transcript of Record

Appeal from the United States District Court
for the District of Hawaii

FILED

APR - 2 1958

PAUL P. O'BRIEN, CLERK

No. 15902

United States
Court of Appeals
for the Ninth Circuit

YOICHI FUJII,

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF ATTORNEYS

For the Plaintiff:

YOICHI FUJII,
A. L. WIRIN, ESQ., and
FRED OKRAND, ESQ.,
257 South Spring Street,
Los Angeles 12, California.

For the Defendant, John Foster Dulles:

LOUIS B. BLISSARD, ESQ.,
United States Attorney, By
CHARLES B. DWIGHT, III, ESQ.,
Asst. U. S. Attorney.,
Federal Building,
Honolulu, Hawaii.

In the District Court of the United States
for the District of Hawaii

Civil No. 1300

YOICHI FUJII,

Plaintiff,

vs.

JOHN FOSTER DULLES, Secretary of State of
the United States of America,

Defendant.

PROCEEDINGS UNDER SECTION 503
UNITED STATES NATIONALITY ACT OF
1940 (8 USCA SECTION 903)

COMPLAINT

Comes now Yoichi Fujii, Plaintiff above named,
and complaining of Defendant above named, shows
as follows:

I.

That the Plaintiff is a citizen of the United States of America by virtue of his birth at Honolulu, City and County of Honolulu, Territory of Hawaii, on December 24, 1916; that the Plaintiff is at present residing at 1172 3-chome, Nakameguro, Meguro-ku, Tokyo, Japan; that the Plaintiff claims the Territory of Hawaii as his permanent residence and intends to reside therein.

II.

That the Defendant, John Foster Dulles, is the Secretary of State of the United States of America;

that the United States Department of State is an agency of the United States Government; and that the United States Foreign Service is a part of the United States Department of State.

III.

That the Plaintiff last resided in the United States of America at Honolulu, aforesaid; that he left the United States on June, 1919, and has resided in Japan since that date.

IV.

That from April, 1941, to September, 1945, the Plaintiff served in the Japanese Armed Forces.

V.

That in April, 1947, the Plaintiff voted in elections in Japan.

VI.

That quite sometime ago, the Plaintiff executed a Petition addressed to the American Consular Service at Tokyo, Japan, for the purpose of securing a passport in order that said Plaintiff might come to the Territory of Hawaii from Japan as an American citizen; that said Petition was supported by the necessary documents and affidavits; that all of the requests of the said American Consulate for information as to the Plaintiff's citizenship have been complied with to the best of the Plaintiff's ability; that the Plaintiff made inquiries of the said American Consulate as to the status of said Petition, but no determination has as yet been made by said Consulate as to said Petition.

VII.

That the non-action and inexcusable delay upon the part of said Consulate to issue to the said Plaintiff said passport is a denial of the Plaintiff's rights and privileges as a United States citizen.

VIII.

That the Plaintiff's service in the Japanese Armed Forces was not his free and voluntary act.

IX.

That the Plaintiff's voting in said elections was not his free and voluntary act.

X.

That in 1947, Japan was not a foreign state and said elections in which the Plaintiff voted were not political elections.

XI.

That as a result of said non-action, the Plaintiff is not able to enter the United States and such is a denial of his rights and privileges as a United States citizen.

XII.

That the Plaintiff claims that he is a United States citizen by virtue of the fact that he was born in the United States of America; that he is entitled to establish and to have this Court declare his United States Nationality under Section 503 of the United States Nationality Act of 1940; that as a citizen and national of the United States, he is entitled to a United States passport and to enter and reside in the United States.

Wherefore, Plaintiff prays for a judgment and decree adjudging that he is a citizen and/or national of the United States of America, and as such, is entitled to the rights and/or privileges of a citizen and/or national of the United States, including the right to be issued a United States passport and a right to enter and reside in the United States of America.

Dated at Honolulu, T. H., this 22nd day of December, A.D. 1952.

YOICHI FUJII,
Plaintiff, By

A. L. WIRIN, FRED OKRAND,
FONG, MIHO, CHOY &
CHUCK,

By /s/ WALTER G. CHUCK,
His Attorneys.

Duly Verified.

[Endorsed]: Filed December 23, 1952.

[Title of District Court and Cause.]

Civil No. 1300

MOTION TO DISMISS

Comes now John Foster Dulles, Secretary of State of the United States of America, Defendant above named, by his attorney, A. William Barlow, United States Attorney for the District of Hawaii, and moves that the Complaint herein be dismissed on the ground that the Plaintiff has failed to state a

claim or cause of action against the Defendant upon which relief can be granted.

Dated: Honolulu, T. H., this 10th day of February, 1953.

A. WILLIAM BARLOW,
United States Attorney,
District of Hawaii;

By /s/ WINSTON C. INGMAN,
Asst. United States Attorney,
District of Hawaii.

[Endorsed]: Filed February 11, 1953.

[Title of District Court and Cause.]

Civil No. 1300

NOTICE OF MOTION FOR LEAVE TO FILE
AMENDED COMPLAINT

To the Defendants Above Named; to Its Attorneys,
A. William Barlow, United States Attorney, and
Louis B. Blissard, Assistant United States At-
torney:

Please Take Notice: On the 9th day of December, 1953, at the hour of 9:00 a.m., before the Honorable Jon Wiig, Judge of the above-entitled Court, or whatever Judge who is handling the affairs of said Judge Wiig in his Courtroom, in the Federal Building, Honolulu, T. H., Plaintiff will move the Court for leave to file the Amended Complaint, a copy of which is attached hereto by reference.

Dated at Honolulu, T. H., this 1st day of December, A.D. 1953.

FONG, MIHO, CHOY & CHUCK,
A. L. WIRIN & FRED OKRAND,

By /s/ K. MIHO,
Attorneys for Plaintiff.

[Title of District Court and Cause.]

Civil No. 1300

AMENDED COMPLAINT

Comes now Yoichi Fujii, Plaintiff above named, and complaining of Defendants above named, shows as follows:

I.

That the Plaintiff is a citizen of the United States of America by virtue of his birth at Honolulu, City and County of Honolulu, Territory of Hawaii, on December 24, 1916; that the Plaintiff is at present residing at 1172 Naka Meguro 2-chome, Meguro Ku, Tokyo, Japan; that the Plaintiff claims the Territory of Hawaii as his permanent residence and intends to reside therein.

II.

That the Defendant, John Foster Dulles, is the Secretary of State of the United States of America; that the United States Department of State is an agency of the United States Government; and that the United States Foreign Service is a part of the United States Department of State.

III.

That the Plaintiff last resided in the United States of America at Honolulu aforesaid; that he left the United States on June, 1919, and has resided in Japan since that date.

IV.

That from April, 1941, to September, 1945, the Plaintiff served in the Japanese Armed Forces.

V.

That in April, 1947, the Plaintiff voted in elections in Japan.

VI.

That quite sometime before the filing of this suit, the Plaintiff executed a Petition addressed to the American Consular Service at Tokyo, Japan, for the purpose of securing a passport in order that said Plaintiff might come to the Territory of Hawaii from Japan as an American citizen; that said Petition was supported by the necessary documents and affidavits; that the Plaintiff was issued a "Certificate of the Loss of the Nationality of the United States," on the ground that the Plaintiff lost his United States citizenship by serving in the Japanese Army; that said disapproval and the refusal by the Consular Service to issue to the Plaintiff a passport is a denial of the Plaintiff's rights and privileges as a United States citizen.

VII.

That Plaintiff's service in the Japanese Armed Forces was not his free and voluntary act.

VIII.

That as a result of said disapproval and denial by said Consular Service, the Plaintiff is not able to enter the United States of America and such a denial of his rights and privileges as a United States citizen.

Wherefore, the Plaintiff prays for judgment and a decree adjudging that the Plaintiff did not lose his United States citizenship by virtue of his service in the Japanese Armed Forces, pursuant to Section 401 (c) of the Nationality Act of 1940, and that he is a citizen and/or national of the United States of America and as such is entitled to the rights and/or privileges including the right to be issued a United States passport and the right to enter and reside in the United States of America.

Dated at Honolulu, T. H., this 1st day of December, A.D. 1953.

YOICHI FUJII,

Plaintiff, By

FONG, MIHO, CHOY & CHUCK,
A. L. WIRIN, FRED OKRAND,

By /s/ K. MIHO,

His Attorneys.

Duly Verified.

Receipt of Copy acknowledged.

[Endorsed]: Filed December 2, 1953.

[Title of District Court and Cause.]

Civil No. 1300

AMENDED AND SUPPLEMENTAL
COMPLAINT

Plaintiff alleges:

I.

Plaintiff, Yoichi Fujii, is a citizen of the United States. He was born at Honolulu, Territory of Hawaii, on December 24, 1916. He claims the Territory of Hawaii, within this district as his permanent residence.

II.

Defendant, John Foster Dulles, is the Secretary of State of the United States of America. As such he is the head of the Department of State.

III.

From April, 1941, to September, 1945, Plaintiff served in the Japanese Armed Forces. In April, 1947, Plaintiff voted in elections held in Japan.

IV.

Plaintiff's service in said Armed Forces was not his free and voluntary act. Plaintiff's voting in said elections was not his free and voluntary act.

V.

On or about October 29, 1952, Plaintiff applied at the Consular Division of the American Embassy in Tokyo, Japan, to be registered as a citizen of the United States. Said Consular officials did not reg-

ister Plaintiff as a citizen of the United States on the day he applied therefor. Instead, on December 29, 1952, the American Vice Consul at Tokyo executed as to Plaintiff a Certificate of the Loss of the Nationality of the United States on the ground that Plaintiff had lost his United States citizenship by reason of his said service in the Japanese Armed Forces. Said Certificate was approved by the Department of State in Washington, D. C., on July 23, 1953, and sent to the Plaintiff by the said Consular Office on September 25, 1953.

Wherefore, Plaintiff prays for judgment declaring that he is a National of the United States and did not lose his United States citizenship by reason of his service in the Japanese Armed Forces or by reason of his having voted in said election in Japan in April, 1947.

Dated at Honolulu, Territory of Hawaii this 25th day of June, 1954.

YOICHI FUJII,
Plaintiff, By

FONG, MIHO, CHOY & CHUCK,
A. L. WIRIN, FRED OKRAND,

By /s/ K. MIHO,
His Attorneys.

Duly Verified.

[Endorsed]: Filed June 25, 1954.

[Title of District Court and Cause.]

Civil No. 1300

MOTION TO STRIKE AND MOTION TO DIS-
MISS AMENDED AND SUPPLEMENTAL
COMPLAINT

The Defendant moves the court as follows:

1. To strike from the Plaintiff's Amended and Supplemental Complaint the following:

All that part of Paragraph V appearing on Page 2 which starts with "Instead, on December 29, 1952 * * *"

For the grounds of this Motion Defendant, John Foster Dulles, says that the allegations are immaterial and impertinent and are supplemental matters not allowed by the court in its ruling filed herein on May 28, 1954.

2. To dismiss the action because the Complaint fails to state a claim against the Defendant upon which relief can be granted.

For grounds of this Motion Defendant, John Foster Dulles, says that the Amended and Supplemental Complaint fails to cure the defects contained in the previous Complaint, which defects were found by Judge Wiig to justify granting Defendant's Motion to Dismiss.

Dated: Honolulu, T. H., this 7th day of July,
1954.

A. WILLIAM BARLOW,
United States Attorney,
District of Hawaii;

By /s/ LOUIS B. BLISSARD,
Asst. United States Attorney,
District of Hawaii.

[Title of District Court and Cause.]

Civil No. 1300

NOTICE OF HEARING

To: Fong, Miho, Choy & Chuck,
Suite 202, Alakea Building,
Alakea and King Streets,
Honolulu, T. H., Attorneys for Plaintiff.

Please Take Notice that the Motion to Strike and Motion to Dismiss Amended and Supplemental Complaint herein will be presented to the Honorable J. Frank McLaughlin, Judge of the United States District Court for the District of Hawaii, in his courtroom in the Federal Building, Honolulu, T. H., on Friday, July 23, 1954, at 10:00 a.m., or as soon thereafter as counsel may be heard.

Dated: Honolulu, T. H., this 7th day of July,
1954.

A. WILLIAM BARLOW,
United States Attorney,
District of Hawaii;

By /s/ LOUIS B. BLISSARD,
Asst. United States Attorney,
District of Hawaii.

Receipt of Copy acknowledged.

[Endorsed]: Filed July 7, 1954.

[Title of District Court and Cause.]

Civil No. 1300

ORDER OF DISMISSAL

The Motion to Dismiss of the defendant, John Foster Dulles, having heretofore come on to be heard before the Court; the petitioner having been represented by his counsel, Katsuro Miho, Esquire, and the defendant having been represented by Louis B. Blissard, Esquire, Assistant United States Attorney of this district; the motion having been fully argued and submitted to the Court for decision; the Court having found the motion to be well taken on the ground stated therein, namely, that the plaintiff has failed to state a claim or cause of action against the defendant upon which relief can be granted, be-

cause at the time the instant suit was filed the petitioner had not actually been denied a passport or other right or privilege as a national of the United States; the Court having given the petitioner thirty (30) days within which to amend the complaint if he could plead facts which would state a claim upon which relief could be granted; petitioner having filed on June 25, 1954, an Amended and Supplemental Complaint and the defendant having thereupon on July 7, 1954, filed a Motion to Strike and Motion to Dismiss the Amended and Supplemental Complaint, and this said motion having come on to be heard before the Court on August 24, 1954; the motion having been fully argued and submitted to the Court for decision; the Court having found the motion to be well taken on the ground stated therein, namely, that the Amended and Supplemental Complaint contained allegations which were not amendatory matter which the Court had allowed or anticipated allowing in the leave to file an amended complaint and that the complaint does not state a cause of action against the defendant upon which relief can be granted.

Now, Therefore, It Is Hereby Ordered, Adjudged and Decreed that the portion of Paragraph V on Page 2 of the Amended and Supplemental Complaint beginning with the words "instead, on December 29, 1952," down through the words "September 25, 1953," be stricken and that this cause and the petition herein be and the same are dismissed.

Dated: Honolulu, T. H., this 23rd day of September, 1954.

/s/ JON WIIG,

Judge, United States District
Court.

No Objection as to Form:

/s/ K. MIHO.

Endorsed]: Filed September 23, 1954.

[Title of District Court and Cause.]

Civil No. 1300

MOTION FOR LEAVE OF COURT TO FILE
AMENDMENT TO AMENDED AND SUP-
PLEMENTAL COMPLAINT

The Plaintiff moves for leave of Court to file an Amendment to the Amended and Supplemental Complaint, which said Amendment is submitted herewith and attached hereto.

The Amendment proposed, constitutes a substitution for Paragraph V of the Amended and Supplemental Complaint herein.

It pertains to the same ground set forth in the original Complaint herein, and in the Amended and Supplemental Complaint herein.

See F.R.C.P. 15(c); and Fujii vs. Dulles (CCA9) 224 Federal 2nd 906.

This Motion is based upon all the records and files of this case, and upon the Affidavit of A. L. Wirin submitted herewith.

Dated: Honolulu, T. H., April 27, 1956.

FONG, MIHO, CHOY & CHUCK,
A. L. WIRIN, FRED OKRAND,

By /s/ A. L. WIRIN,
Attorneys for Plaintiff.

[Title of District Court and Cause.]

Civil No. 1300

AFFIDAVIT OF A. L. WIRIN IN SUPPORT
OF MOTION FOR LEAVE TO FILE
AMENDMENT TO AMENDED AND SUP-
PLEMENTAL COMPLAINT

Territory of Hawaii,
City and County of Honolulu—ss.

A. L. Wirin, being first duly sworn, on oath, deposes and says:

That he is one of the attorneys for the Plaintiff in the within case;

That at the time of the filing of the original Complaint herein and at the time of the filing of the Amended and Supplemental Complaint herein, neither the Affiant, nor any of the attorneys for

the Plaintiff knew the facts as set forth in the proposed Amendment to the Amended and Supplemental Complaint. Said facts came to the attention of the Affiant, in April, 1956, when the Affiant conferred personally with the Plaintiff in Tokyo, Japan; and

Further Affiant sayeth naught.

Dated: Honolulu, T. H., April 27, 1956.

A. L. WIRIN.

Subscribed and sworn to before me this 27th day of April, 1956.

[Seal] /s/ WINNIE LIN UNG CHANG,
Notary Public, First Judicial
Circuit Court, Territory of
Hawaii.

My Commission Expires January 31, 1960.

[Title of District Court and Cause.]

Civil No. 1300

AMENDMENT TO AMENDED AND
SUPPLEMENTAL COMPLAINT

V.

In the early part of 1948, the Plaintiff went to the office of the United States Consul at Yokohama, Japan, for the purpose of applying for return to the United States; but the Plaintiff was advised by an official at the office of the United

States Consul, which official spoke both English and Japanese, that the United States Consul was not accepting applications for return to the United States, because of the then Occupation.

In November, 1951, the Plaintiff received a communication from the United States Consul at Tokyo, Japan, a copy of which is annexed hereto, marked Exhibit "A" and incorporated herein by reference. Thereupon, the Plaintiff set about to comply with the various requirements listed in the memorandum, referred to in said Exhibit "A" including a certificate from the proper Japanese Army Authorities pertaining to the details of service by the Plaintiff in the Japanese Army, a statement from the proper authorities at Hiroshima containing the details of the Plaintiff's voting in Hiroshima during the post-war elections in Japan, and, particularly, a record of birth in the United States.

With respect to the last item, the Plaintiff encountered considerable delay because there was no record of the Plaintiff's birth in Hawaii, either at the Board of Vital Statistics or at the office of the Secretary of the Territory of Hawaii at Honolulu; accordingly, it was necessary for the Plaintiff to secure secondary evidence of the Plaintiff's birth in the form of an affidavit of a person qualified to testify to the date and place of birth of the Plaintiff.

In order to secure this secondary evidence, the Plaintiff engaged in extended correspondence with his cousin, George Fujii, who ultimately was able to secure an Affidavit of Identity from Goichi Morioka

of Honolulu. This affidavit was secured in Honolulu on October 24, 1952, was forwarded to the Plaintiff by air mail from Honolulu and was submitted by the Plaintiff to the United States Consul in Tokyo, immediately upon receipt by him of said affidavit in Japan on October 29, 1952. On which date, the Plaintiff filed with said United States Consul, a formal application to establish his United States citizenship, accompanied by all of the documents required by the United States Consul pursuant to the letter from the United States Consul of November 8, 1951, and the requirements listed in the memorandum forwarded to the Plaintiff by said United States Consul as set forth in Exhibit "A" annexed hereto.

The United States Consul at Tokyo with respect to the application by the Plaintiff formally filed on October 29, 1952, did not act promptly thereon, but on the contrary neglected to act formally upon said application; and, inexcusably and arbitrarily postponed action until December 29, 1952, knowing well, during November and December, 1952, that on December 24, 1952, the Immigration and Nationality Act of 1952 was to go into effect.

Additionally, said United States Consul arbitrarily and inexcusably neglected to report his action of December 29, 1952, issuing a Certificate of Loss of Nationality to the Plaintiff, so that said action of said Consul was not approved by the State Department in Washington, D. C., until July 23, 1953.

Dated: Honolulu, T. H., April 27, 1956.

FONG, MIHO, CHOY & CHUCK
A. L. WIRIN & FRED
OKRAND,

By /s/ A. L. WIRIN,
Attorneys for Plaintiff.

EXHIBIT A

The Foreign Service of the United States
of America

Address Official Communication to:
American Consular Service,

Norin Chuo Kinko, 9 Yuraku-cho,
1-chome, Chiyoda Ku, Tokyo.

November 8, 1951.

Mr. Yoichi Fujii,
1172 Naka Meguro 3-chome,
Meguro Ku, Tokyo.

Sir:

Reference is made to previous correspondence between you and the Consulate at Yokohama.

It is noted that you have never made formal application to establish your claim to citizenship. You are invited therefore to apply for registration or for a passport to return to the United States. There is enclosed a memorandum entitled "American Citizenship of Persons of Japanese Ancestry Resi-

dent in Japan," which lists the items which are required in connection with an application for registration or passport. It is suggested that you comply with all the requirements listed in the memorandum, and then forward to this office the last page of the memorandum which is a request for appointment to establish your claim to citizenship. An application may be made by you even in the event that you have performed an act which apparently resulted in the loss of United States citizenship.

Very truly yours,

RICHARD D. NETHERCUT,
American Vice Consul.

Enclosure:

Memorandum.

[Endorsed]: Filed April 30, 1956.

[Title of District Court and Cause.]

Civil No. 1300

**MOTIONS TO SET ASIDE AND RELIEVE
PLAINTIFF OF (a) ORDER OF DISMISSAL
AND (b) ORDER STRIKING PORTIONS
OF AMENDED AND SUPPLEMENTAL
COMPLAINT**

To the defendant, above named, and to his attorney, Louis B. Blissard, United States Attorney,
Please Take Notice:

1. Plaintiff moves the court to set aside and relieve plaintiff of the order of dismissal dated September 23, 1954.

2. Upon the granting of said Motion, plaintiff moves the court to set aside its order of September 23, 1954, striking portions of Paragraph V of the Amended and Supplemental Complaint.

These motions are made on the ground that the first motion comes within the provisions of Rule 60(b) (6), Federal Rules of Civil Procedure and that the second was error in law which should be corrected by the court. Said motions are based on the affidavit and Memorandum of Points and Authorities attached hereto, and upon all the records and files of this case.

Dated: April 27, 1956.

FONG, MIHO, CHOY AND
CHUCK,

A. L. WIRIN & FRED
OKRAND,

By /s/ FRED OKRAND,
Attorneys for Plaintiff.

[Title of District Court and Cause.]

Civil No. 1300

AFFIDAVIT OF KATSURO MIHO

Territory of Hawaii,
City and County of Honolulu—ss.

Katsuro Miho, being first duly sworn, on oath,
deposes and says:

That he is one of the attorneys for the Plaintiff
in the within action;

That at the time this Court considered and passed
upon the Defendant's Motion to Dismiss the
Amended and Supplemental Complaint, on August
24, 1954, the Affiant requested the Court to defer
decision until action by the Court of Appeals for
the Ninth Circuit in the case of Junso Fujii vs.
Dulles, 1261, in this Court and then pending on ap-
peal in the Court of Appeals for the Ninth Circuit
(14460 therein), counsel for the Defendant herein
objected to this Court deferring its decision, and a
colloquy occurred between the Affiant, the United
States Attorney and the Court. As the result of
said colloquy, the Affiant was under the impression
that it was not necessary for the Plaintiff herein to
take an appeal from the Court's ruling; and that in
the event the Judgment then on appeal in the said
Junso Fujii case were reversed by the Court of Ap-
peals, the Plaintiff might proceed herein to take ad-
vantage of any favorable ruling in said Junso Fujii
case. Accordingly, the Plaintiff herein did not ap-
peal to the Court of Appeals for the Ninth Circuit

from the Order of the Court herein dismissing the Amended and Supplemental Complaint; and

Further Affiant sayeth naught.

Dated: Honolulu, T. H., April 27, 1956.

/s/ KATSURO MIHO,

Subscribed and sworn to before me this 27th day of April, 1956.

[Seal] /s/ WINNIE LIN UNG CHANG,
Notary Public, First Judicial Circuit, Territory of Hawaii.

My commission expires: 1-31-60.

[Endorsed]: Filed April 30, 1956.

In the United States District Court
for the District of Hawaii
Civil No. 1487

YOICHI FUJII,

Plaintiff,

vs.

JOHN FOSTER DULLES, Secretary of State of
the United States of America,

Defendant.

COMPLAINT

(For Declaration as to United States Citizenship)

Plaintiff alleges:

I.

Plaintiff, Yoichi Fujii, is a citizen of the United States. He was born at Honolulu, Territory of Ha-

waii, on December 24, 1916. He claims the Territory of Hawaii, within this district as his permanent residence. He is now temporarily in Japan.

II.

Defendant, John Foster Dulles, is the Secretary of State of the United States of America. As such he is the head of the Department of State.

III.

This court has jurisdiction under Section 503, Nationality Act of 1940 (8 USC 903) and Section 405(a), Immigration and Nationality Act of 1952 (note to 8 USC 1101).

IV.

From April, 1941, to September, 1945, plaintiff served in the Japanese Armed Forces. In April, 1947, plaintiff voted in elections held in Japan.

V.

Plaintiff's service in said Armed Forces was not his free and voluntary act. Plaintiff's voting in said elections was not his free and voluntary act.

VI.

In the early part of 1948 the plaintiff went to the office of the United States Consul at Yokohama, Japan, for the purpose of applying for return to the United States; but the plaintiff was advised by

an official at the office of the United States Consul, which official spoke both English and Japanese, that the United States Consul was not accepting applications for return to the United States, because of the then Occupation.

In November, 1951, the plaintiff received a communication from the United States Consul at Tokyo, Japan, a copy of which is annexed hereto, marked Exhibit "A" and incorporated herein by reference. Thereupon, the plaintiff set about to comply with the various requirements listed in the memorandum, referred to in said Exhibit "A" including a certificate from the proper Japanese Army Authorities pertaining to the details of service by the plaintiff in the Japanese Army, a statement from the proper authorities at Hiroshima containing the details of the plaintiff's voting in Hiroshima during the post-war elections in Japan, and particularly, a record of birth in the United States.

With respect to the last item, the plaintiff encountered considerable delay because there was no record of the plaintiff's birth in Hawaii, either at the Board of Vital Statistics or at the office of the Secretary of the Territory of Hawaii at Honolulu; accordingly, it was necessary for the plaintiff to secure secondary evidence of the plaintiff's birth in the form of an affidavit of a person qualified to testify to the date and place of birth of the plaintiff.

In order to secure this secondary evidence, the plaintiff engaged in extended correspondence with

his cousin, George Fujii, who ultimately was able to secure an Affidavit of Identity from Goichi Morioka of Honolulu. This affidavit was secured in Honolulu on October 24, 1952, was forwarded to the plaintiff by air mail from Honolulu and was submitted by the plaintiff to the United States Consul in Tokyo immediately upon receipt by him of said Affidavit in Japan on October 29, 1952. On which date, the plaintiff filed with said United States Consul, a formal application for a passport as a United States citizen. Said application was accompanied by all of the documents required by the United States Consul pursuant to the letter from the United States Consul of November 8, 1951, and the requirements listed in the memorandum forwarded to the plaintiff by said United States Consul as set forth in Exhibit "A" annexed hereto.

The United States Consul at Tokyo with respect to the application by the plaintiff formally filed on October 29, 1952, did not act promptly thereon, but on the contrary neglected to act formally upon said application and inexcusably and arbitrarily postponed action until December 29, 1952, knowing well, during November and December, 1952, that on December 24, 1952, the Immigration and Nationality Act of 1952 was to go into effect.

Additionally, said United States Consul arbitrarily and inexcusably neglected to report his action of December 29, 1952, issuing a Certificate of Loss of Nationality to the plaintiff, so that said action of said Consul was not approved by the State

Department in Washington, D. C., until July 23, 1953.

By said action, the consular officials in Tokyo and the State Department officials in Washington acted as the agents of and for and on behalf of defendant and his predecessor in office and denied to plaintiff a right and privilege as a national of the United States on the ground that he is not a national thereof.

Wherefore, plaintiff prays for judgment declaring that he is a National of the United States and did not lose his United States citizenship by reason of his service in the Japanese Armed Forces or by reason of his having voted in said election in Japan in April, 1947.

Dated: June 4, 1956.

YOICHI FUJII,

Plaintiff, By

FONG, MIHO, CHOY AND
CHUCK,

A. L. WIRIN & FRED
OKRAND,

His Attorneys,

By /s/ FRED OKRAND.

Duly verified.

EXHIBIT A

The Foreign Service of the United States
of America

Address Official Communication to:

American Consular Service,

Norin Chuo Kinko, 9 Yuraku-cho,

1-chome, Chiyoda Ku, Tokyo.

November 8, 1951.

Mr. Yoichi Fujii,

1172 Naka Meguro 3-chome,

Meguro Ku, Tokyo.

Sir:

Reference is made to previous correspondence between you and the Consulate at Yokohama.

It is noted that you have never made formal application to establish your claim to citizenship. You are invited therefore to apply for registration or for a passport to return to the United States. There is enclosed a memorandum entitled "American Citizenship of Persons of Japanese Ancestry Resident in Japan," which lists the items which are required in connection with an application for registration or passport. It is suggested that you comply with all the requirements listed in the memorandum, and then forward to this office the last page of the memorandum which is a request for appointment to establish your claim to citizenship. An application may be made by you even in the event that you

have performed an act which apparently resulted in the loss of United States citizenship.

Very truly yours,

RICHARD D. NETHERCUT,
American Vice Consul.

Enclosure:

Memorandum.

[Endorsed]: Filed June 6, 1956.

[Title of District Court and Cause.]

Civil No. 1300

ORDER DENYING MOTION

A Motion to Set Aside Order of Dismissal filed in this matter on September 23, 1954, being filed on April 30, 1956, the matter having been fully argued and the plaintiff having been represented by his attorneys, A. L. Wirin, Esq., and Katsuro Miho, Esq.; and the defendant having been represented by his attorneys, Louis B. Blissard, United States Attorney for the District of Hawaii, and Charles B. Dwight III, Assistant United States Attorney for the District of Hawaii; and this Court having filed on June 20, 1956, a Ruling on Motion to Set Aside Order of Dismissal, finding the motion to be without merit:

It Is Hereby Ordered, Adjudged and Decreed that the Motion to Set Aside Order of Dismissal filed herein be and hereby is denied.

Dated Honolulu, T. H., this 11th day of July, 1956.

/s/ JON WIIG,

Judge, United States District
Court for the District of
Hawaii.

Approved as to Form:

/s/ K. MIHO,

Attorney for Plaintiff.

[Endorsed]: Filed July 11, 1956.

[Title of District Court and Cause.]

Civil No. 1487

MOTION TO DISMISS

Comes now John Foster Dulles, Secretary of State of the United States of America, defendant above named, by his attorneys, Louis B. Blissard, United States Attorney for the District of Hawaii, and E. D. Crumpacker, Assistant United States Attorney for the District of Hawaii, and hereby moves to dismiss the above-entitled action for the reason

that it appears upon the face of the complaint that the Court lacks jurisdiction of the subject matter, as more fully appears in the memorandum attached hereto.

Dated: Honolulu, T. H., this 6th day of August, 1956.

LOUIS B. BLISSARD,
United States Attorney, District of Hawaii, At-
torney for Defendant.

By /s/ E. D. CRUMPACKER,
Asst. United States Attorney.

[Title of District Court and Cause.]

Civil No. 1487

NOTICE

To: Fong, Miho, Choy & Chuck, 197 So. King Street, Honolulu, T. H., and A. L. Wirin & Fred Okrand, 257 So. Spring Street, Los Angeles 12, Calif., Attorneys for Plaintiff.

Please Take Notice that the foregoing Motion will be heard before the Honorable J. Frank McLaughlin, Judge of the above-entitled Court, in his courtroom in the Federal Building, Honolulu, T. H., on Monday, August 13, 1956, at 10:00 a.m., or as soon thereafter as counsel may be heard.

Dated: Honolulu, T. H., this 6th day of August, 1956.

LOUIS B. BLISSARD,
United States Attorney, District of Hawaii, At-
torney for Defendant.

By /s/ E. D. CRUMPACKER,
Asst. United States Attorney.

[Endorsed]: Filed August 6, 1956.

[Title of District Court and Cause.]

Civil No. 1487

MOTION FOR SUMMARY JUDGMENT

Defendant, John Foster Dulles, Secretary of State of the United States of America, by his attorneys Louis B. Blissard, United States Attorney for the District of Hawaii, and Charles B. Dwight III, Assistant United States Attorney for the District of Hawaii, moves the Court to enter, pursuant to Rule 56 of the Federal Rules of Civil Procedure, a summary judgment in favor of Defendant and against Plaintiff on the ground that there is no genuine issue as to any material fact establishing that the questions presented by the Complaint filed herein have been decided upon the merits by this Court in Civil No. 1300, Yoichi Fujii v. John Foster Dulles, and that the Defendant is entitled to judgment as a

matter of law. This Motion is based upon the Memorandum of Points and Authorities and upon the records and files herein and in Civil No. 1300 in the United States District Court for the District of Hawaii.

Dated: Honolulu, T. H., this 4th day of June, 1957.

LOUIS B. BLISSARD,
United States Attorney, District of Hawaii, At-
torney for Defendant.

By /s/ CHARLES B. DWIGHT, III,
Asst. United States Attorney.

[Title of District Court and Cause.]

Civil No. 1487

NOTICE

To: Fong, Miho, Choy & Chuck, 197 South King Street, Honolulu, T. H., and A. L. Wirin & Fred Okrand, 257 South Spring Street, Los Angeles, California, Attorneys for Plaintiff.

You Are Hereby Notified that the foregoing Motion will be heard before the Honorable Jon Wiig, Judge of the United States District Court for the District of Hawaii, in his courtroom in the Federal Building, Honolulu, T. H., on the 14th day of June, 1957, at the hour of 2:00 p.m. on said date, or as soon thereafter as counsel may be heard.

Dated: Honolulu, T. H., this 4th day of June, 1957.

LOUIS B. BLISSARD,
United States Attorney, District of Hawaii, Attor-
ney for Defendant;

By /s/ CHARLES B. DWIGHT, III,
Asst. United States Attorney.

Receipt of copy acknowledged.

[Endorsed]: Filed June 4, 1957.

[Title of District Court and Cause.]

Civil No. 1487

RULING ON MOTION TO DISMISS
AND FOR SUMMARY JUDGMENT

On December 23, 1952, plaintiff, Yoichi Fujii, filed a complaint (Civil No. 1300) in this Court, seeking a judgment that he was a citizen of the United States of America. It was alleged that the Court had jurisdiction under § 503 of the United States Nationality Act of 1940, 8 USCA, § 903. Plaintiff alleged that he was a citizen of the United States by virtue of his birth in Honolulu, Hawaii, on December 24, 1916; that his service in the Japanese Armed Forces was involuntary; that his voting in Japanese elections was involuntary; and that he had been denied the rights and privileges as a United States citizen because of the failure of the American Con-

sular Service at Tokyo, Japan, to issue a United States passport to him.

On September 23, 1954, the complaint as amended and supplemented was ordered and adjudged dismissed on Defendant's motion on the ground that it failed to state a claim or cause of action against the Defendant upon which relief could be granted because at the time the complaint was filed the plaintiff had not actually been denied a passport or other right or privilege as a national of the United States. Some nineteen (19) months later (April 30, 1956), plaintiff filed a Motion to Set Aside the Order of Dismissal, seeking relief under the provisions of Rule 60(b)(6), Federal Rules of Civil Procedure, which motion was denied primarily on the ground that the rule was not a substitute for an appeal. An order and judgment denying the motion was signed and filed on July 11, 1956, from which order and judgment an appeal was perfected to the Court of Appeals. This appeal was dismissed agreeably to a stipulation of counsel in September, 1956.

In the meantime, on June 6, 1956, plaintiff filed in this Court a petition seeking a similar determination as to his citizenship under 8 USCA, § 903 and § 405(a) of the Immigration and Nationality Act of 1952, note to 8 USCA, § 1101. The new complaint contained substantially the same allegations of fact as those set forth in the final complaint in Civil No. 1300. It is significant that nothing new was added which filled the voids in the earlier amended and supplemental complaint so that it could survive the

hurdle of a Motion to Dismiss on the ground that it failed to state a claim or cause of action against the Defendant upon which relief could be granted.

The Defendant moved to dismiss this complaint on the ground that, from its face, it appears that the Court lacks jurisdiction of the subject matter, and subsequently filed a motion for Summary Judgment pursuant to Rule 56, Federal Rules of Civil Procedure, on the ground that there is no genuine issue as to any material fact establishing that the questions presented by this complaint had been decided upon on their merits by the Court in Civil No. 1300, and that the Defendant is entitled to a judgment as a matter of law. Both motions will be considered as one for summary judgment.

It is recognized that, in this type of action, it is desirable that the law and the facts be construed in such a manner as to avoid a loss of citizenship¹, but such construction is restricted by other rules of civil procedure. A plaintiff in a nationality case, like any other plaintiff, feeling that the trial court has erred, must take an appeal to obtain a reversal.

Rule 41(b) of the Federal Rules of Civil Procedure cannot be strictly applied at or after trials, but in this case must be read conjunctively with Rule 12(b)(6). The Court is aware that a motion to dismiss cannot be substituted for a trial on the merits, 1 Federal Practice and Procedure (Barron and Holtzoff) 608, § 349 n. 79, but such is not our concern. "This motion [to dismiss] has been de-

clared on the one hand to be essentially the same as a demurrer * * *” 1 Federal Practice and Procedure (Barron and Holtzoff) 603, § 348, n. 65; “* * * [and] performs the function formerly performed by a demurrer.” *Flanigan v. Security-First National Bank*, D.C. S. D. Cal. 1941, 41 F. Supp. 77, 79. “A decree entered upon demurrer is no less effective as *res judicata* than a decree rendered upon proof.” *Sacks v. Stecker*, 62 F.2d 65, 66 citing cases.²

Rule 41(b) of the Federal Rules of Civil Procedure when considered with Rule 12(b)(6) provides that a dismissal for failure to state a claim or cause of action upon which relief can be granted is an adjudication upon the merits and such a determination is an appealable order. Likewise, the order and judgment denying the Motion to Set Aside the Order of Dismissal in Civil No. 1300 was an appealable order. It is significant that neither judgment in Civil No. 1300 provided that the judgments did not amount to adjudications of the merits of the case. Each judgment was approved by plaintiff’s counsel. “A judgment dismissing an action after dismissal of the complaint for failure to state a claim is *res judicata* and bars another action on the same claim.” 2 Moore’s Federal Practice (2nd Ed.) par. 12.14, p. 2267.

The Court, having taken judicial notice of *Yoichi Fujii v. Dulles*, Civil No. 1300, in this Court³ and having allowed matters outside the pleading to be presented,⁴ finds that defendant’s Motion for Sum-

mary Judgment is timely presented. Rule 56, Federal Rules of Civil Procedure.

“A motion for summary judgment may be used by the defendant to assert the defense that plaintiff’s claim has been determined in another action and that the prior judgment is res judicata.”

3 Federal Practice and Procedure (Barron and Holtzoff) 128 § 1246 n. 86.⁵

There being no genuine issue as to any material fact, as a matter of law, the defendant is entitled to Summary Judgment.

Motions granted.

Dated at Honolulu, Hawaii, this 22nd day of November, 1957.

/s/ JON WIIG,

United States District Judge.

Footnotes

¹Schneiderman v. U. S., 302 U. S. 118, 122; Junso Fujii v. Dulles, 224 F.2d 906, 907.

²Old Dominion Copper Mining and Smelting Co. v. Lewisohn, 202 F. 178; Northern Pacific Ry. v. Slight, 202 U. S. 122, 27 S. Ct. 442, 51 L. Ed. 738, 106 A.L.R. 437; W. E. Hedger Transp. Corporation v. Ira S. Bushey & Sons, Inc., E. D. N. Y. 1950, 92 F. Supp., 112, affirmed 186 F.2d, 236.

³Fletcher v. Evening Star Newspaper Co., D. C. Cir. 1942, 133 F.2d 395; Daley v. Sears, Roebuck & Co., N. D. Ohio, 1950, 90 F. Supp. 562, affirmed 182 F.2d 347.

⁴Fletcher v. Evening Star Newspaper Co., *supra*.

⁵Billings Utility Co. v. Advisory Committee, Board of Governors, 8 Cir. 1943, 135 F.2d 108; Daley v. Sears, Roebuck & Co., *supra*; 348 Bloomfield Avenue Corp. v. Montclair Mfg. Co., Inc., N. J. 1950, 90 F. Supp., 1020; Weekley v. Pennsylvania R. Co., E. D. Ill. 1952, 104 F. Supp. 899; Hadden, et al., v. United States, C. Cl. 1952, 105 F. Supp. 1010; R. V. Kimble v. Anderson-Tully Company, E.D. Ark. 1955, 16 F. R. D. 502.

[Endorsed]: Filed November 22, 1957.

In the United States District Court
for the District of Hawaii

Civil No. 1487

YOICHI FUJII,

Plaintiff,

vs.

JOHN FOSTER DULLES, Secretary of State of
the United States of America,

Defendant.

ORDER AND JUDGMENT

This matter having come on for hearing on Motion to Dismiss and for Summary Judgment on June 10, 1957, Plaintiff having been represented by A. L. Wirin, Esquire, and the Defendant having been represented by Louis B. Blissard, United States Attorney for District of Hawaii, and Charles B.

Dwight III, Assistant United States Attorney for the District of Hawaii; the matter having been fully argued and considered, and a Ruling on Motion to Dismiss and for Summary Judgment having been filed on November 22, 1957; Now, Therefore, It Is Hereby

Ordered, Adjudged and Decreed that the Motion for Summary Judgment by the Defendant be and it is hereby granted and, It Is

Further Ordered that Summary Judgment be and it is hereby entered for the Defendant.

Dated: New York, N. Y., this 16th day of December, 1957.

/s/ JON WIIG,
Judge, United States District Court for the District
of Hawaii.

No Objection as to Form:

FONG, MIHO, CHOY & CHUCK
ROY E. TAKUSHI, A. L.
WIRIN & FRED OKRAND,
Attorneys for Plaintiff,

By /s/ FRED OKRAND.

[Endorsed]: Filed and entered December 20,
1957.

[Title of District Court and Cause.]

Civil No. 1487

NOTICE OF APPEAL

Notice Is Hereby Given that Yoichi Fujii, plaintiff above named, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the judgment entered in this action on December 20, 1957.

Dated: This 17th day of December, 1957.

ROY E. TAKUSHI, A. L. WIRIN
& FRED OKRAND,

By /s/ FRED OKRAND,
Attorneys for Appellant.

Receipt of Copy acknowledged.

Affidavit of Service by Mail attached.

[Endorsed]: Filed December 20, 1957.

[Title of District Court and Cause.]

Civil No. 1487

ORDER EXTENDING TIME TO FILE RECORD AND DOCKET APPEAL

It is by the Court this 17th day of February, 1958,
Ordered:

That the time for filing the record on appeal and docketing the appeal in the United States Court

of Appeals for the Ninth Circuit be, and it hereby is, extended to and including February 28, 1958.

/s/ J. FRANK McLAUGHLIN,
United States District Judge.

[Endorsed]: Filed February 17, 1958.

[Title of District Court and Cause.]

Civil No. 1300

DOCKET ENTRIES

1952

- Dec. 23—Filing Complaint. Issuing Summons, certifying four copies, three for service, five to U. S. Marshal.
- Dec. 24—Filing U. S. Marshal's Return on Service of Writ (served).

1953

- Feb. 11—Filing Motion to Dismiss and Memorandum of Points and Authorities.
- Dec. 2—Filing Notice of Motion for Leave to File Amended Complaint.
- Dec. 28—Entering Proceedings — Motion set for hearing December 30, 1953, at 9 a.m.
- Dec. 30—Entering Proceedings at hearing on Motion — Arguments — Ruling Deferred — to file memos by January 20, 1954.

1954

- Jan. 14—Filing Stipulation and Order, etc. February 19, 1954.

1954

- Feb. 18—Filing Plaintiff's Memorandum in Support of Motion for Leave to file Amended Complaint and of Motion for Joinder of Additional Parties Plaintiff.
- Feb. 19—Filing Stipulation and Order Enlarging Time (March 24, 1954).
- Mar. 18—Filing Plaintiff's Supplemental Memorandum in Support of Motion for Leave to File Amended Complaint and of Motion for Joinder of Additional Parties Plaintiff.
- Mar. 23—Defendants' Memorandum in Opposition to Motion for Leave to File Amended Complaint and to Motion for Joinder of Additional Parties Plaintiff filed
- May 28—Ruling on Motion to Amend and Motion to Dismiss Complaint filed (Wiig). (Motion to dismiss granted—30 days to amend.)
- June 25—Amended and Supplemental Complaint filed.
- July 7—Motion to Strike, Motion to Dismiss Amended and Supplemental Complaint and Notice of Hearing filed.
- Aug. 24—Entering proceedings at hearing on Motion to Strike and Motion to Dismiss—Arguments by Counsel—Motion to Strike Granted—Motion to Dismiss Granted—Order to be signed upon presentation.
- Sept. 23—Order of Dismissal filed.

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- Apr. 30—Notice of Motions: 1. To set aside and relieve plaintiff of: (a) Order of Dismissal and (b) Order striking portions of amended and supplemental complaint; 2. For leave of Court to file amendment to amended and supplemental complaint filed.
- Apr. 30—Motion for leave of court to file amendment to amended and supplemental complaint—Affidavit of A. L. Wirin in support of motion for leave to file amendment to amended and supplemental complaint—Amendment to amended and supplemental complaint filed.
- Apr. 30—Motions to set aside and relieve plaintiff of: (a) Order of Dismissal and (b) Order Striking Portions of Amended and Supplemental Complaint; Affidavit; Points and Authorities.
- May 2—Memorandum in Opposition to Motion to Set Aside and Relieve Plaintiff of Order of Dismissal and Order Striking portions of Amended and Supplemental Complaint filed.
- May 11—Entering proceedings at hearing on Motions to Set Aside Order of Dismissal, etc.—Arguments by Wirin and Miho for petitioner and Dwight for defendant—Matter taken under advisement.
- June 20—Ruling on Motion to Set Aside Order of Dismissal filed. Wiig—Motion Denied.

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June 20—Copies mailed to A. L. Wirin, Los Angeles, Calif.; Fong, Miho, Choy and Chuck, Honolulu, T. H.

June 20—Copy to U. S. Attorney.

July 11—Order Denying Motion filed. Wiig. Copy to U. S. Attorney, Miho and Wirin.

July 30—Notice of Appeal filed.

July 30—Statement of Points upon which Appellant Intends to Rely on Appeal filed.

July 30—Designation of Record on Appeal filed.

July 30—U. S. Attorney advised by letter with copy of Notice of Appeal attached.

Aug. 1—Counter-Designation of Record on Appeal filed.

Aug. 17—Transcript of Proceedings filed—Original—August 24, 1954.

[Title of District Court and Cause.]

Civil No. 1487

CERTIFICATE OF CLERK

United States of America,
District of Hawaii—ss.

I, William F. Thompson, Jr., Clerk of the United States District Court for the District of Hawaii, do hereby certify that the foregoing record on appeal in the above-entitled cause, numbered from Page 1 to Page 38a, consists of a statement of the names and addresses of the attorneys of record and of the

various original pleadings as hereinbelow listed and indicated:

Complaint.

Motion to Dismiss, Memorandum of Points and Authorities, and Notice.

Motion for Summary Judgment, Memorandum of Points and Authorities, and Notice.

Ruling on Motion to Dismiss and for Summary Judgment.

Order and Judgment.

Notice of Appeal.

Designation of Contents of Record on Appeal.

Order Extending Time to File Record and Docket Appeal.

I further certify that I have included herewith, Pages numbered from 42 to 83, the original pleadings in Civil No. 1300 of this Court, Yoichi Fujii, vs. John Foster Dulles, etc., as hereinbelow listed and indicated:

Complaint.

Motion to Dismiss and Memorandum of Points and Authorities.

Notice of Motion for Leave to File Amended Complaint.

Amended and Supplemental Complaint.

Motion to Strike, Motion to Dismiss Amended and Supplemental Complaint, and Notice of Hearing.

Order of Dismissal.

Motion for Leave of Court to File Amendment to Amended and Supplemental Complaint.

Affidavit of A. L. Wirin, etc., Amendment to Amended and Supplemental Complaint.

Motions to Set Aside and Relieve Plaintiff of: (a) Order of Dismissal and (b) Order Striking Portions of Amended and Supplemental Complaint; Affidavit; Points and Authorities.

Order Denying Motion.

I further certify that included herewith is a copy of the Docket Entries in Civil No. 1300.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said Court this 18th day of February, 1958.

[Seal] /s/ WM. F. THOMPSON, JR.,
Clerk.

[Endorsed]: No. 15902. United States Court of Appeals for the Ninth Circuit. Yoichi Fujii, Appellant, vs. John Foster Dulles, Secretary of State of the United States, Appellee. Transcript of Record. Appeal from the United States District Court for the District of Hawaii.

Filed February 19, 1958.

Docketed: February 24, 1958.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the
Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit
No. 15902

YOICHI FUJII,

Appellant,

vs.

JOHN FOSTER DULLES, Secretary of State of
the United States of America,
Defendant.

STATEMENT OF POINTS ON WHICH AP-
PELLANT INTENDS TO RELY; AND
DESIGNATION OF THE PORTIONS OF
THE RECORD MATERIAL TO THE AP-
PEAL.

Pursuant to Rule 17(6) of This Court, Appellant
States the Following as the Points on Which he
Intends to Rely:

1. The trial court erred in granting defendant's
Motion to Dismiss;
2. The trial court erred in granting defendant's
Motion for Summary Judgment;
3. The trial court erred in entering Summary
Judgment for defendant.

Dated: March 5, 1958.

ROY E. TAKUSHI,

A. L. WIRIN & FRED OKRAND,

By /s/ FRED OKRAND,

Attorneys for Appellant.

[Endorsed]: Filed March 6, 1958.

United States
COURT OF APPEALS
for the Ninth Circuit

W. A. RUSHLIGHT; RAYMOND G. RUSHLIGHT; W. A.
RUSHLIGHT COMPANY, a partnership; W. A. RUSH-
LIGHT, Executor of the Estate of Betty Rushlight, deceased,
Appellants,

v.

UNITED STATES OF AMERICA,

Appellee.

UNITED STATES OF AMERICA,

Appellant,

v.

W. A. RUSHLIGHT; RAYMOND G. RUSHLIGHT; W. A.
RUSHLIGHT COMPANY, a partnership; W. A. RUSH-
LIGHT, Executor of the Estate of Betty Rushlight, deceased,
Appellees.

APPELLANTS' AND CROSS-APPELLEES' BRIEF

*Appeals from the United States District Court for the
District of Oregon.*

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United States
COURT OF APPEALS
for the Ninth Circuit

W. A. RUSHLIGHT; RAYMOND G. RUSHLIGHT; W. A.
RUSHLIGHT COMPANY, a partnership; W. A. RUSH-
LIGHT, Executor of the Estate of Betty Rushlight, deceased,
Appellants,

v.

UNITED STATES OF AMERICA,

Appellee.

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Appellant,

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APPELLANTS' AND CROSS-APPELLEES' BRIEF

*Appeals from the United States District Court for the
District of Oregon.*

STATEMENT OF JURISDICTION

The jurisdiction of the District Court is based upon 28 U.S.C. § 1345 and Sec. 403(c) of the Renegotiation Act (P.L. 528, 77th Cong., 2d Sess., 56 Stat. 245, as amended; 50 U.S.C.A. Appendix, § 1191; pertinent provisions of which are printed in the appendix). Appellee

brought a civil action to recover excessive profits as determined under the Renegotiation Act (R. 28).

The District Court granted a final summary judgment in favor of the appellee (R. 67-71). Appellants gave timely notice of appeal (R. 71).

This court has jurisdiction to review the judgment under 28 U.S.C. § 1291.

STATEMENT OF THE CASE

This is a civil action under the Renegotiation Act to recover the amount of excessive profits which a partnership (W. A. Rushlight Company) received during 1942 on its sales and contracts subject to renegotiation. Appellants are three of the four partners of the partnership. The appeal is from the final order of the District Court granting the appellee's motion for a summary judgment. There is no dispute as to the principal amount of the judgment or the propriety of its entry in a summary manner if the lower court was correct in (a) striking the Second Defense of the appellants, and (b) sustaining the objections to appellants' Requests for Admissions.

The challenged action of the District Court was based upon the following allegations in the Third Amended and Supplemental Complaint (R. 28) which are admitted in the First Defense of appellants' answer thereto (R. 33-34):

Complaint

Appellants were members of a partnership engaged in construction work; under the Renegotiation Act the Secretary of War on December 18, 1945 determined that \$80,000 of the profits realized by the partnership during 1942 on its contracts and sub-contracts subject to renegotiation were excessive profits; the partnership filed a petition with the Tax Court of the United States for the redetermination of the amount of its excessive profits; on September 5, 1956, the Tax Court entered its order and decision that the partnership realized excessive profits in the sum of \$66,700 for the year 1942; the tax credit authorized is the sum of \$10,553.98; on April 20, 1954 the sum of \$7,815.03 otherwise due one of the partners was applied by appellee toward the partnership's renegotiation liability for 1942.

Based upon the foregoing admitted facts the District Court entered a summary judgment against appellants in the sum of \$48,330.99, together with interest thereon at the rate of $4\frac{1}{4}\%$ per annum from September 5, 1956, the date of the Tax Court decision. The appellee has cross appealed on the ground interest should have been allowed from January 8, 1946, the date of demand under the original determination (R. 11).

The following is an outline of the allegations of appellants' Second Defense (R. 34-37):

Second Defense

Appellants were members of the partnership which, during the years 1942, 1943, 1944 and 1945, had contracts and sales which were subject to renegotiation under the Renegotiation Act; after 1945 the partnership had no renegotiable sales, and is in the process of liquidation; incorporated in said defense as Exhibit A (R. 37) is a summary of the profits and losses of the partnership on all of its contracts and sales subject to renegotiation, being those for the years 1942, 1943, 1944 and 1945; for said years the partnership realized profits on its renegotiable contracts and sales in the sum of \$8,-686.68 without taking into account as an expense reasonable compensation for services performed by its partners; if reasonable compensation had been allowed for the partners' services there would have been no profits whatever realized by the partnership on its contracts and sales subject to renegotiation; in arriving at the amount of excessive profits realized by the partnership for 1942 neither the Secretary of War nor the Tax Court gave any consideration to the overall profits and losses of the partnership, although appellants offered to prove that their profits subject to renegotiation were as shown in Exhibit A; no relief has ever been granted to the appellants for any of the losses suffered by them for the years 1944 and 1945 on their renegotiable contracts and sales.

Supplementing the allegations in their Second De-

fense, and pursuant to Rule 31(a), Federal Rules of Civil Procedure, appellants requested appellee to admit that the following facts are true (R. 39-42):

Requests for Admissions

Exhibit A incorporated in the Second Defense is a true and correct copy of an exhibit prepared jointly by counsel for the parties in the Tax Court renegotiation proceeding; it was stipulated in the Tax Court proceeding that the exhibit is a correct summary showing the profits and losses on renegotiable sales for the partnership for the years 1942, 1943, 1944 and 1945 after the settlement of all income tax disputes between the partners and the Internal Revenue Service; in its petition to the Tax Court the partnership had alleged that its overall profits and losses should be taken into consideration in determining whether it had received excessive profits for 1942; in the Tax Court proceeding Exhibit A was offered in evidence by appellants, but the Tax Court ordered that evidence bearing on the partnership's profits and losses for years subsequent to 1942 was inadmissible; in the Tax Court proceeding no consideration was given to the profits and losses of the partnership on renegotiable business for years subsequent to 1942; the partnership and its partners have not been reimbursed for any of their losses for 1944 and 1945; in arriving at the totals shown in Exhibit A no allowance was made for salaries for the partners.

In opposition to the appellee's motion for summary judgment the appellants filed an affidavit that all of the foregoing statements in the Requests for Admissions are true (R. 60).

Appellee moved to strike appellants' Second Defense under Rule 12(f), Federal Rules of Civil Procedure (R. 43); filed objections to the appellants' Requests for Admissions under Rule 36(a) of the same rules (R. 42); and moved for a summary judgment (R. 44-57); all on the grounds that the facts alleged in the Second Defense do not constitute a defense; the District Court had no jurisdiction to consider the same; and the decision of the Tax Court was *res judicata*. The District Court granted both motions and sustained the objections.

SPECIFICATIONS OF ERROR

The District Court erred in:

1. Striking the Second Defense;
2. Sustaining the objections to the Requests for Admissions;
3. Granting the motion for summary judgment.

QUESTION PRESENTED

1. The Tax Court determined that a partnership had received excessive profits of \$66,700 on its renegotiable contracts and sales for 1942.

2. Although the Tax Court did not do so, if consideration is given to all of the partnership's renegotiable

contracts and sales (being for the war years 1942 to 1945, inclusive) it did not receive *any* profits.

3. The United States brought a civil action in the District Court to recover the \$66,700 excessive profits for 1942.

Does the fact that the partnership on an overall basis did not receive *any* profits constitute a defense which can be asserted in the District Court action?

SUMMARY OF ARGUMENT

This is an action to recover excessive profits received by the appellants. Such an action is governed by equitable principles and is subject to equitable defenses. It can only be maintained if the appellants in equity and good conscience are indebted to the appellee. The appellants' Second Defense shows that the appellee's action is unjust, inequitable and oppressive because defendants did not receive excessive profits—in fact, they had losses. The Second Defense is cognizable only by a court having general equitable powers. Therefore, the decision of the Tax Court is not *res judicata* and the District Court had jurisdiction to consider the Second Defense.

ARGUMENT

I. The Purpose of the Renegotiation Act.

To arrive at a correct and just decision in this case, it is necessary first to determine the purpose of the Renegotiation Act and this action brought thereunder.

In *Lichter v. United States*, 334 US 742, 68 S Ct 1294, 92 L ed 1694, the court discusses the Act in detail and outlines its history, purpose and the philosophy underlying it. The Act was sustained as a war measure designed to prevent war time profiteering. As the court said, "In total war it is necessary that a civilian make sacrifices of his property and profits with at least the fortitude that a drafted soldier makes his traditional sacrifices . . ." After describing the procedures under the Act, the court said that "Resulting injustices can and should be carefully examined and as far as possible relieved."

To summarize the holding of the court in the *Lichter* case, we think it is fair to say that the Renegotiation Act is not a revenue measure—it was passed for the purpose of preventing the profiteering which has been a traditional part of our wars. It attempts to somewhat equalize the sacrifices of the civilian population with the sacrifices of those called into the armed services. Within the procedures set by the Act the government was given a method of recovering from war contractors excessive profits which they might realize. Resulting injustices should be carefully examined and, as far as possible, relieved. The Tax Court had the exclusive jurisdiction to determine the amount of excessive profits "and such determination shall not be reviewed or redetermined by any court or agency" (Renegotiation Act). Although the District Court could consider the constitutional issue, it could not pass on any issue that could properly be brought before the Tax Court. (See *French v. War Contracts Price Adjustment Board*, 9

Cir., 1950, 182 F2d 560, where this court recognizes that, at least as to constitutional issues, they can be raised in the District Court collection suit after the Tax Court proceeding is determined—even though to do so would extend litigation. As we shall later show, the issue raised in the case at bar by appellants' Second Defense falls in the same category as a constitutional issue. *It is not such an issue as could have been passed upon by the Tax Court, an administrative tribunal with no equitable powers.*)

II. To Allow Appellee to Recover Is Unjust, Oppressive and Inequitable.

Having in mind the purpose of the Renegotiation Act, let us examine the facts before the District Court. Admittedly the partnership did receive excessive profits amounting to \$66,700 in 1942. The Tax Court so determined "and such determination shall not be reviewed or redetermined by any court or agency" (Renegotiation Act). However, if the facts deemed immaterial by the District Court are considered, rather than realizing excessive profits the partnership sustained a loss on its war contracts and sales. For the four war years (including 1942) the partnership made a total profit of only \$8,686.68, and this without allowing compensation for services performed by the partners. This figure should be reduced by the \$7,815.03 which appellee recovered from one of the partners, leaving a balance of \$871.65 total profit. The Tax Court reduced the original \$80,000 determination for 1942 by \$13,300 because no allowance was made for salaries for the partners (R. 55). If a

like modest allowance were made for 1943, 1944 and 1945 rather than a profit of \$871.65, the partnership would have a loss of \$52,328.35.

If the District Court's judgment is affirmed, in addition to the loss, the partners will have heaped upon them a judgment for \$48,330.99 plus interest. Such judgment will have been obtained under a law designed not as a penalty—not as a revenue measure—but as a measure to prevent the partnership from making excessive profits on its war contracts and sales. The question in this case is simply whether or not such an oppressive, unjust and inequitable result must follow. As we shall show, it need not and should not follow, as the District Court is the proper and only forum which can grant relief from such a result.

III. The Nature of Appellee's Action and the Equitable Powers of a District Court.

Although necessarily and justifiably restricted, there is an area—narrow but nevertheless recognized—in which a court of general jurisdiction can apply the equitable principles inherent in our legal system, even in litigation between the sovereign and its citizens.

Based upon ancient precedents and principles the United States Supreme Court has recognized an area in which equitable principles will be applied even in a field as strictly statutory as that of federal taxation. The leading cases are *Bull v. United States*, 295 US 247, 55 S Ct 695, 79 L ed 1421 (applying equitable recoupment in favor of a taxpayer) and *Stone v. White*, 301 US 532,

57 S Ct 851, 81 L ed 1265, mdfd 302 US 639, 58 S Ct 260, 82 L ed 497 (applying equitable recoupment in favor of the government). In the latter case the court analyzes the basic nature of an action between the sovereign and a citizen based upon a duty to pay money imposed by law (not on contract express or implied). Such is the case at bar. The court says that such an action is "the lineal successor of the common count in *indebitatus assumpsit* for money had and received." The court then says of such an action that, "Its use to recover upon rights equitable in nature to avoid unjust enrichment by the defendant at the expense of the plaintiff, and its control in every case by equitable principles, established by Lord Mansfield in *Moses v. Macferlan*, 2 Burr 1005, 97 Eng. Reprint 676 (K.B. 1750), have long been recognized . . ." Continuing, the court says that "Since the plaintiff must recover by virtue of a right measured by equitable standards, it follows that it is open to the defendant to show any state of facts which, according to those standards, would deny the right." The court says that this case (action against government) is the converse of the *Bull* case and *United States v. MacDaniel*, 7 Pet. 1, *infra*, and *United States v. Ringgold*, 8 Pet. 150, *infra*, in which "equitable recoupment against a claim by the government was allowed notwithstanding the immunity of the government from suit."

Based upon the reasoning in the *Stone* case, appellants' Second Defense is a complete defense on either of two distinct and valid bases. In the first place, it shows that appellee's claim is inequitable, oppressive

and unjust, and should not be sustained. Independently of that, it shows that appellants did not and have not received excessive profits which in equity and good conscience should be returned to the government. Appellants did not make any profits on the war effort—in fact they sustained a loss. Furthermore, this loss grew out of the same transaction and set of facts out of which the appellee's action arose, namely, the partnership's activities as a World War II contractor with contracts and sales subject to renegotiation under the Act. Appellants are not seeking to assert a counter-claim against the government for their losses, or to recover the \$7,815.03 appellee has received on account of "excessive profits." They are merely seeking to defeat appellee's claim on the equitable grounds pleaded in their Second Defense.

IV. Recoupment and the Application of Equitable Principles to Actions by the United States as Sovereign.

In *United States v. MacDaniel*, 32 US 1, 7 Pet. 1, 8 L ed 587, the United States brought an action of *assumpsit* against a clerk in the Navy Department to recover a balance due on his account. The clerk had acted as a disbursing agent and under the prevailing custom was entitled to a commission on his disbursements equal to the amount for which he was sued. The court said that even though the defendant's rights were equitable in nature he could assert them as an offset against the amount he owed the government. The court said that it could not "see any right, either legal or

equitable, in the government, to the sum of money for the recovery of which this action is brought.”

United States v. Ringgold, 33 US 150, 8 Pet. 150, 8 L ed 899, involved the same principles and reasoning in an *assumpsit* action by the United States against a marshal who was entitled to certain poundage fees. The foregoing two cases are relied upon in the *Bull* and *Stone* cases, and illustrate the fact that a defendant can assert defenses, equitable in nature, to offset and defeat a claim by the government, even though the defensive matters could not be made the subject of a separate suit or counterclaim.

An old case even closer in point is *Clinkenbeard v. United States*, 88 US 65, 21 Wall. 65, 22 L ed 477. In this case the United States brought an action of debt to collect the amount of a tax based upon the gallonage capacity of a distillery. The tax had been assessed by the collector and no appeal had been taken as allowed by law. As a defense the distiller offered to prove that during a period of eight days his distillery had been shut down because of certain actions of the government, and he therefore could not have owed a capacity tax for those days. There, as in the case at bar, the government claimed that the assessment was “*res judicata* and conclusive, and defendant was precluded from showing the contrary.” In allowing the defense, the court said that “to charge him with the capacity tax during those eight days was unjust and oppressive.” The court said that, while the distiller could not sue without first appealing from the assessment, this was a case brought by the government and

“no statute is cited to show that he cannot, when thus sued, set up the defense that the tax was illegally assessed, although he may not have appealed to the Commissioner.”

In *United States v. Pusey*, 9 Cir. 1931, 47 F2d 22, this court recognized the distinction between (a) a counterclaim for damages or a setoff of some unrelated claim, and (b) a defense in the nature of recoupment going to the merits of the government's action. In this case, the United States sued to recover estate taxes that previously had been erroneously refunded to the defendant. The defendant admitted that the refund had been erroneously made. However, defendant pleaded as a defense that the estate taxes had in the first instance been overpaid and therefore defendant was not in fact indebted to the United States. Although the defendant's affirmative pleading was denominatd a “counterclaim” it was conceded that it could not be allowed as such because no claim had ever been filed by the defendant for the overpayment. However, this court allowed the defense because the government's action was based on the proposition that the original tax was correct and the defendant could plead and prove otherwise even though he could not counterclaim.

In *American Propeller & Manufacturing Company v. United States*, 300 US 475, 57 S Ct 521, 81 L ed 751, the court had before it a case in which there was present the same element as in the case at bar, namely, because of certain statutory law, the government's position was unjust and inequitable. In this case, the plaintiff had a meritorious damage claim against the

government which did not bear interest. The government had a meritorious claim in a smaller amount which did bear interest. If the claims had been offset when they arose, the government owed the plaintiff money. If not, the plaintiff owed the government a large sum for which it was counterclaiming. At the bar of the Supreme Court, government counsel admitted that its claim was inequitable but insisted that this result followed from the statute. In this regard, the court said:

“We have said [*United States v. The Thekla* (Luckenbach S. S. Co. v. The Thekla) 266 US 328, 339-341, 69 L Ed. 313, 315, 316, 45 S Ct 112] —‘when the United States comes into court to assert a claim, it so far takes the position of a private suitor as to agree by implication that justice may be done with regard to the subject matter. The absence of legal liability in a case where, but for its sovereignty, it would be liable, does not destroy the justice of the claim against it . . . the reasons are strong for not obstructing the application of natural justice against the government by technical formulas when justice can be done without endangering any public interest’. If the principle thus stated is not strictly applicable, it at least suggests that the court should not affirm what is clearly an unjust and inequitable result unless under plain compulsion of law.”

There are several recent cases (not admiralty cases) in which the courts of appeal have held that when the United States asserts a claim it so far takes the position of a private suitor as to agree by implication that justice may be done with regard to the subject matter. In this connection see *Jacobs v. United States*, 4 Cir., 1956, 239 F2d 459; *Lacey v. United States*, 5 Cir., 1954,

216 F2d 223; *In re Greenstreet, Inc.*, 7 Cir., 1954, 209 F2d 660.

In the latter case, after carefully reviewing the authorities, the court summarized them by saying:

"The postulate to be distilled from the cases is, as we have observed, that the United States, by initiating an action as plaintiff, consents to the jurisdiction of the court to entertain any defensive plea including the right of setoff to the extent of the government's claim, but does not thereby consent to an affirmative judgment on a counterclaim. Stated differently, this consent empowers the court to decide all issues necessary to dispose of the general claim initiated by the government, but does not, as in the case of private litigants under the Federal Rules, extend to power to decide separate affirmative claims which the defendant may have by way of counterclaim."

For a case in this court holding that by bringing an action the United States does not consent to the filing of affirmative counterclaims against it, see *United States v. Finn*, 9 Cir., 1956, 239 F2d 679.

In an article, "Government Immunity From Counterclaims," 50 *Columbia Law Review* 505, 509, the author states:

"The reason for permitting recoupment against the United States is not that the Government, by instituting suit, submits the entire transaction upon which its claim is based to the jurisdiction of the court. Rather, recoupment is said to be essentially defensive, and, concededly, sovereign immunity is not elastic enough to bar defenses going to the merits of the Government's claim."

See also 3 *Moore's Federal Practice*, Sec. 1302, Note 1, where the author says that the "matter of recoupment

may, without statutory authority, be asserted against the sovereign by counterclaim to defeat recovery, but setoff and other independent claims may not be, unless there is statutory authority therefor."

Thus, we have shown that in the extremely rare but proper case, the courts have always recognized that a defendant, when sued by the United States, may show equitable matters. Such matters may relate to the equity or enforceability of the government's claim. Or, such matters may show that the defendant is not indebted to the United States because of some facet or aspect of the transaction on which the United States is suing. In the case at bar, the United States is suing for excessive profits when there were in fact no profits as is shown by the Second Defense.

V. The Tax Court Had No Jurisdiction to Consider the Facts Alleged in the Second Defense.

In its order striking the appellants' Second Defense and sustaining the objections to appellants' Requests for Admissions, the District Court recited that the matters raised therein "are matters of law which were fully determined by the Tax Court's determination and that this court does not have jurisdiction of the matters so raised." (R. 66).

It must be conceded that the Tax Court did not have these matters before it, as both the Second Defense and the Requests for Admissions state that the Tax Court ruled that evidence bearing on profits for years subsequent to 1942 was inadmissible and that the Tax Court

gave no consideration to the profits and losses of the partnership for years subsequent to 1942.

Of course, if the Tax Court *could* have considered these facts, then the matter would be *res judicata*, since that doctrine would apply not only to issues that were litigated before the Tax Court but also to issues which could have been litigated.

However, the Tax Court was clearly correct in holding that the matters in the Second Defense could not be considered by that "court." The Renegotiation Act itself makes this clear in that it specifically provides in Sec. 403(a)(4)(C) that "notwithstanding any of the provisions of this section to the contrary, no amount shall be allowed as an item of cost . . . (ii) by reason of the application of a carryover or carryback under any circumstances."

It is also clear that the Tax Court had no right to consider an equitable defense or matters in the nature of recoupments, since the Tax Court is not really a court at all, but an administrative agency having no equitable powers. This is made clear in the case of *Commissioner v. Gooch Milling & Elevator Co.*, 320 US 418, 64 S Ct 184, 88 L Ed 139. In this case the taxpayer sought to have the Board of Tax Appeals (now Tax Court) apply the doctrine of equitable recoupment by eliminating a 1936 deficiency because of an overpayment of 1935 taxes. In upholding the Board's refusal to consider this matter, the Supreme Court stated at pages 419-422:

"We hold that the Board's position was correct

and that it had no jurisdiction to . . . apply any overpayment of the taxes for the 1935 fiscal year against the 1936 deficiency.

“The . . . legislative pattern of . . . [the Board’s] jurisdiction is clear and unambiguous. The Board is confined to a determination of the amount of deficiency or overpayment for the particular tax year as to which the Commissioner determines a deficiency and as to which the taxpayer seeks a review of the deficiency assessment. . . .

“The Board’s want of jurisdiction to apply the doctrine of equitable recoupment in this case is manifest. . . .

“We are not called upon to determine the scope of equitable recoupment when it is asserted in a suit for refund of taxes in tribunals possessing general equity jurisdiction. Cf. Bull v. United States, 295 US 247; Stone v. White, 301 US 532. But its use in proceedings before the Board is governed by the circumscribed jurisdiction of that agency. The Internal Revenue Code, not general equitable principles, is the mainspring of the Board’s jurisdiction. Until Congress deems it advisable to allow the Board to determine the overpayment or underpayment in any taxable year other than the one for which a deficiency has been assessed, the Board must remain impotent when the plea of equitable recoupment is based upon an overpayment or underpayment in such other year.” (Emphasis supplied)

This court had occasion recently to examine the powers of the Tax Court in the case of *Lasky v. Commissioner of Internal Revenue*, 9 Cir. 1956, 235 F2d 97, in which the question arose as to whether or not the Tax Court had the power to vacate one of its decisions, a power that would rest in a District Court. In discussing the powers of the Tax Court, this court

said of that body that "Though not a court at all but merely an administrative agency it assumed the power of a district court . . ." and vacated its own decision. It is interesting to note that the contention was made that the Tax Court is "like other courts" and has the "inherent power to control, amend, open and vacate its decisions." This contention was summarily rejected. The United States Supreme Court affirmed this court in a *per curiam* opinion (See *Lasky v. Commissioner*, 352 US 1037, 77 S Ct 594, 1 L Ed 2d 598).

Thus it can be seen that the one and only forum that could hear the equitable defense pleaded by the appellants is the District Court, and the Tax Court was absolutely correct when it refused to consider the matters raised in the Second Defense. As previously stated, this court recognized in the case of *French v. War Contracts Price Adjustment Board*, *supra*, that there are issues which can be raised in the District Court renegotiation collection suit which could not properly be brought before the Tax Court. In that case the issue mentioned was a constitutional issue. By the same reasoning, this also would be true as to an equitable defense which could not be raised in the Tax Court since that body is clearly but an administrative agency without the equitable powers of the District Court.

CONCLUSION

Appellants' Second Defense and the related Requests for Admissions show that appellant have an equitable defense to this action. The District Court erred in its rulings concerning the same and in entering a summary judgment against appellants. This case should be reversed and remanded to the District Court for trial on the merits.

Respectfully submitted,

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Attorneys for Appellants and
Cross Appellees.

APPENDIX

Section 403(c) of the Renegotiation Act (P.L. 528, 77th Congress, 2d Sess., 56 Stat. 245), provided, in part, as follows:

“Sec. 403 (c). (1) Whenever, in the opinion of the Secretary of a Department, the profits realized or likely to be realized from any contract with such Department, or from any subcontract thereunder whether or not made by the contractor, may be excessive, the Secretary is authorized and directed to require the contractor or subcontractor to renegotiate the contract price. When the contractor or subcontractor holds two or more contracts or subcontracts the Secretary in his discretion, may renegotiate to eliminate excessive profits on some or all of such contracts and subcontracts as a group without separately renegotiating the contract price of each contract or subcontract.

“(2) Upon renegotiation, the Secretary is authorized and directed to eliminate any excessive profits under such contract or subcontract

“(i) by reductions in the contract price of the contract or subcontract or by other revision in its terms; or

“(ii) by withholding, from amounts otherwise due to the contractor or subcontractor, any amount of such excessive profits; or

“(iii) by directing a contractor to withhold for the account of the United States, from amounts otherwise due to the subcontractor, any amount of such excessive profits under the subcontract; or

“(iv) by recovery from the contractor or subcontractor, through repayment, credit or suit, of any amount of such excessive profits actually paid to him; or

“(v) by any combination of these methods, as the Secretary deems desirable. *The Secretary may bring actions on behalf of the United States in the appropriate courts of the United States to recover from such contractor or subcontractor, any amount of such excessive profits actually paid to him and not withheld or eliminated by some other method under this subsection.* The surety under a contract or subcontract shall not be liable for the repayment of any excessive profits thereon. All money recovered by way of repayment or suit under this subsection shall be covered into the Treasury as miscellaneous receipts.

“(3) In determining the excessiveness of profits realized or likely to be realized from any contract or subcontract, the Secretary shall recognize the properly applicable exclusions and deductions of the character which the contractor or subcontractor is allowed under Chapter 1 and Chapter 2 E of the Internal Revenue Code. In determining the amount of any excessive profits to be eliminated hereunder the Secretary shall allow the contractor or subcontractor credit for Federal income and excess profits taxes as provided in Section 3806 of the Internal Revenue Code.” (Emphasis supplied)

[Note: The above section was a part of the original Renegotiation Act of 1942. By Section 701 (b) of the Revenue Act of 1943 (P.L. 235, 78th Congress, 58 Stat. 78) the foregoing section was amended and appears in 50 U.S.C.A. Appendix Section 1191, in its amended form. The Amendment was effective for fiscal years ending subsequent to June 30, 1943. The appellee's action was brought under the above section.]

Section 403 (a)(4)(C) of the Renegotiation Act states, in part:

“Notwithstanding any of the provisions of this

section to the contrary, no amount shall be allowed as an item of cost * * * (ii) by reason of the application of a carry-over or carry-back under any circumstances."

[Note: The above was one of the retroactive amendments made by Section 701 (b) of the Revenue Act of 1943 (Renegotiation Act).]

Section 403 (e) of the Renegotiation Act provides:

"Sec. 403 (e). (1) Any contractor or subcontractor aggrieved by an order of the Board determining the amount of excessive profits received or accrued by such contractor or subcontractor may, within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the last day) after the mailing of the notice of such order under section (c) (1), file a petition with The Tax Court of the United States for a redetermination thereof. Upon such filing such court shall have exclusive jurisdiction, by order, to finally determine the amount, if any, of such excessive profits received or accrued by the contractor or subcontractor, and such determination shall not be reviewed or redetermined by any court or agency. The court may determine as the amount of excessive profits an amount either less than, equal to, or greater than that determined by the Board. A proceeding before the Tax Court to finally determine the amount, if any, of excessive profits shall not be treated as a proceeding to review the determination of the Board, but shall be treated as a proceeding *de novo*. For the purposes of this subsection the court shall have the same powers and duties, insofar as applicable, in respect of the contractor, the subcontractor, the Board and the Secretary, and in respect of the attendance of witnesses and the production of papers, notice of hearings, hearings before divisions, review by the Tax Court of decisions of divisions, stenographic reporting, and reports of proceedings, as such court has under sec-

tions 1110, 1111, 1113, 1114, 1115 (a), 1116, 1117 (a), 1118, 1120, 1121 of the Internal Revenue Code in the case of a proceeding to redetermine a deficiency.
* * *

“(2) Any contractor or subcontractor (excluding a subcontractor described in subsection (a) (5) (B)) aggrieved by a determination of the Secretary made prior to the date of the enactment of the Revenue Act of 1943, with respect to a fiscal year ending before July 1, 1943, as to the existence of excessive profits, which is not embodied in an agreement with the contractor or subcontractor, may, within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the last day) after the date of the enactment of the Revenue Act of 1943, file a petition with The Tax Court of the United States for a redetermination thereof, and any such contractor or subcontractor aggrieved by a determination of the Secretary made on or after the date of the enactment of the Revenue Act of 1943, with respect to any such fiscal year, as to the existence of excessive profits, which is not embodied in an agreement with the contractor or subcontractor, may, within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the last day) after the date of such determination, file a petition with The Tax Court of the United States for redetermination thereof. Upon such filing such court shall have the same jurisdiction, powers, and duties, and the proceeding shall be subject to the same provisions, as in the case of a petition filed with the court under paragraph (1), except that the amendments made to this section by Revenue Act of 1943 which are not made applicable as of April 28, 1942, or to fiscal years ending before July 1, 1943, shall not apply.”

In the United States Court of Appeals
for the Ninth Circuit

W. A. RUSHLIGHT; RAYMOND G. RUSHLIGHT; W. A.
RUSHLIGHT COMPANY, a partnership; W. A. RUSH-
LIGHT, Executor of the Estate of Betty Rushlight,
deceased, APPELLANTS,

v.

UNITED STATES OF AMERICA, APPELLEE AND CROSS-
APPELLANT

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF OREGON

BRIEF FOR THE UNITED STATES AS APPELLEE AND
CROSS-APPELLANT

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**In the United States Court of Appeals
for the Ninth Circuit**

No. 15909

W. A. RUSHLIGHT; RAYMOND G. RUSHLIGHT; W. A. RUSHLIGHT COMPANY, a partnership; W. A. RUSHLIGHT, Executor of the Estate of Betty Rushlight, deceased, APPELLANTS,

v.

UNITED STATES OF AMERICA, APPELLEE AND CROSS-
APPELLANT

*ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF OREGON*

BRIEF FOR THE UNITED STATES AS APPELLEE AND
CROSS-APPELLANT

STATEMENT OF JURISDICTION

This suit was filed against appellants by the United States in the United States District Court of Oregon under § 403(c) (2) (iv) of the Renegotiation Act of 1942 (56 Stat. 245, 982, 57 Stat. 348, 564; 50 U.S.C. App. 1191, *infra*, p. 31) “to recover * * * excessive profits” made by appellants during 1942 on certain Government war subcontracts.

The District Court, on December 5, 1957, granted summary judgment for the United States in the amount of \$48,330.99 plus interest from September 5,

1956 (R. 67-71). Each party filed a timely notice of appeal (R. 71-72). The defendants below¹ appeal from the order granting the Government's motion for summary judgment. The Government cross-appeals from the holding limiting it to interest from September 5, 1956 rather than from the date of demand, January 8, 1946 (R. 78-80).

This Court has jurisdiction to review the judgment below under 28 U.S.C. 1291.

STATEMENT OF THE CASE

Appellants are partners in a partnership known as W. A. Rushlight Company, organized on March 12, 1942 with its principal place of business during the year 1942 in Portland, Oregon (R. 47). During the period March 27, 1942 to December 31, 1942, the appellants received or accrued \$471,485 primarily from the performance of Government contracts or subcontracts for the installation of plumbing and heating equipment at Walla Walla Air Base, Washington (R. 48, 52, 53). These sales were subject to renegotiation under the Renegotiation Act of 1942. 56 Stat. 245, 982; 57 Stat. 348, 564. (R. 52).

From these sales, appellants realized profits, before renegotiation, amounting to \$137,392, or 29.2% of sales (R. 37). In accordance with the provisions of the Renegotiation Act, the War Department Price Adjustment Board, on December 18, 1945, unilaterally determined that appellants had realized excessive profits in the amount of \$80,000 from its renegotiable contracts

¹ By stipulation, the parties have agreed that in this proceeding in this Court defendants below shall be designated as "appellants" and that plaintiff below shall be designated as "appellee" and "cross-appellant".

during the period March 27, 1942 to December 31, 1942 (R. 6-10). On the same date, appellants were notified of the determination of \$80,000 by the Chairman of the War Department Price Adjustment Board (R. 11) who, at the same time, formally demanded payment of the principal amount of the renegotiation debt. The demand letter further advised appellants that, if payment, less an applicable tax credit, were not made before January 8, 1946, interest would accrue on the indebtedness at the rate of 6% per annum from and after that date (R. 10-11). To this date, appellants have not voluntarily paid any part of the debt. However, the sum of \$7,815.03 was withheld in 1954 from monies otherwise due the estate of one of the partners and was applied to a reduction of accrued interest (R. 31, 34).

Within the ninety days after the Board's determination and pursuant to § 403(e)(2) of the Renegotiation Act of 1943 (58 Stat. 78; 50 U.S.C. App. 1191, *infra*, p. 33), appellants filed a petition in the Tax Court of the United States seeking a redetermination of their excessive profits for March 27, 1942 to December 31, 1942 (R. 30). After a trial on the merits, the Tax Court, on September 5, 1956, entered an order, based on detailed findings of fact and an opinion, redetermining appellants excessive profits in the amount of \$66,700 (R. 32, 46-55). Appellants filed a petition to review the Tax Court's decision in the Court of Appeals for the District of Columbia Circuit but, on December 17, 1956, sought and obtained dismissal of their petition before the case was docketed (R. 57).

In the meanwhile, the Government, on November 26, 1946, and as authorized by § 403(c) of the 1942

Renegotiation Act, filed a complaint in the District Court of the United States for the District of Oregon seeking to recover the unpaid 1942 excessive profits of \$80,000 less applicable tax credit (R. 3-12).² Following the September 5, 1956 Tax Court decision, the Government filed a third amended complaint asking for judgment in the amount of \$66,700 (the Tax Court's redetermined amount of excessive profits) less tax credit of \$10,553.98, making the debt sued for \$56,146.02 plus interest at the rate of $4\frac{1}{4}\%$ per annum from January 8, 1946 to the date of judgment less \$7,815.03 applied to accrued interest as of April 20, 1954, plus costs (R. 28-32).

In their answer, appellants admitted the Tax Court determination of \$66,700 and that the tax credit applicable to such \$66,700 was \$10,553.98, thus eliminating any issue as to the amount of the principal debt. (R. 33). However, appellants' answer further alleged, as a second defense, that they had losses from renegotiable sales for the years 1944 and 1945 and that the Tax Court had refused to give consideration to the 1944 and 1945 losses (R. 34-37). Appellants alleged that they, accordingly, had no 1942 excessive profits

² An amended complaint was filed on June 6, 1949, asserting that appellants were entitled to a tax credit under the Internal Revenue Code of 1939 in the amount of \$42,013, leaving a net principal debt due the United States of \$37,987. The Government prayed judgment for such sum plus interest at the rate of 6% per annum from January 8, 1946 (R. 15-19). On April 12, 1955, the Government filed a second amended complaint alleging that the proper tax credit under the Code was \$17,136.29, leaving a revised net principal amount due of \$62,863.71. The Government prayed for judgment in that amount plus interest at the rate of $4\frac{1}{4}\%$ per annum from January 8, 1946 to and including the date of payment less the sum of \$7,815.03 applied to accrued interest in 1954, plus costs (R. 24-27).

and prayed the Government's complaint be dismissed (R. 33-37).

In addition, appellants filed Requests for Admissions in the District Court, asking the Government to admit (1) that in the Tax Court proceeding, appellants had offered in evidence a schedule (R. 37) designed to show their losses for the years 1944 and 1945 (R. 39-41), and (2) that the Tax Court had sustained the Government's objections to the admission in evidence of profits and losses for years subsequent to 1942 on the ground that such material was irrelevant and incompetent (R. 41).³

On April 2, 1957, the Government filed objections to appellants' requests for admissions and filed a motion to strike appellee's second defense (R. 42-44). On the same day, the Government moved for summary judgment, asserting, among other things, that the District Court did not have jurisdiction to review or redetermine matters decided by the Tax Court, that the decision of the Tax Court was *res judicata*, that there was no dispute or question of fact relating to the amount of the debt flowing from the determination of excessive profits which had been finally and conclusively determined for 1942 by the Tax Court (R. 44-45).

On December 5, 1957, the District Court, after concluding that it lacked jurisdiction to consider matters raised in the Tax Court and that the Tax Court's determination of the amount of the principal debt

³ In the Tax Court, the Government successfully argued (R. 41) that appellants were attempting to circumvent the Renegotiation Act's statutory prohibition against "carry-over or carry-back [of losses] under any circumstances" by trying to offset 1944 and 1945 losses against 1942 excessive profits. 50 U.S.C. App. 1191. *Infra*, p. 30.

sought was *res judicata* and binding on the District Court, (1) granted the Government's motion to strike the second defense, (2) sustained the Government's objections to appellants' requests for admissions, and (3) awarded the Government summary judgment against appellants in the sum of \$48,330.99 plus interest at the rate of $4\frac{1}{4}\%$ per annum from and after September 5, 1956 (R. 65, 66, 67, 68, 70, 71).⁴

SPECIFICATION OF ERROR ON CROSS-APPEAL

The Government, on its cross-appeal, contends that the District Court erred in awarding the Government interest from September 5, 1956 in lieu of awarding it interest from January 8, 1946.⁵ (R. 79, 80)

SUMMARY OF ARGUMENT

I. This is an appeal from a summary judgment in which the United States recovered a renegotiation debt. The amount of the debt was finally determined by the Tax Court, in the exercise of its exclusive jurisdiction, and the Tax Court's determination of the principal amount of a renegotiation debt is by statute conclusive

⁴ The District Court reduced the principal of \$56,146.02 sought in the Government's complaint to \$48,330.99 because, in denying the Government interest before September 5, 1956, he applied the \$7,815.03 withheld in 1954 to principal rather than to accrued interest.

⁵ If, as we believe, the judge erred in limiting the Government to interest from September 5, 1956, rather than from January 8, 1946, then it follows that the Court below should be directed to enter judgment in the principal amount of \$56,146.02 (plus interest from January 8, 1946) rather than in the amount of \$48,330.99. The judge's entry of judgment for the latter amount is due to his failure to award interest from 1946 and to his application of the 1954 withholding, amounting to \$7,815.03, to reduction of the principal rather than to reduction of interest properly accruing since 1946.

and not reviewable. *United States v. California Eastern Line, Inc.*, 348 U.S. 351; *Bass v. United States*, 221 F. 2d 494 (C.A. 8), cert. den. 350 U.S. 827.

The Tax Court's determination of the principal amount of the debt is *res judicata* and for that additional reason may not be challenged or disturbed in the present collection proceeding. *Bass v. United States*, *supra*; *Ring Construction Corp. v. United States*, 102 F. Supp. 569 (C. Cls.), cert. den., 343 U.S. 953; *United States v. Ring Construction Corp.*, 178 F. 2d 714, cert. denied, 339 U.S. 943.

Under similar circumstances and whether or not a contractor has filed a petition in the Tax Court, courts in the Ninth Circuit have consistently granted the Government's motions for summary judgment. *Sampson Motors, Inc. v. United States*, 168 F. 2d 878; *United States v. Pownall*, 65 F. Supp. 147, aff'd., 159 F. 2d 73, aff'd., 334 U.S. 742; *United States v. Bonnell*, 180 F. 2d 145; *United States v. Clark*, 72 F. Supp. 393 (Ore.).

Realizing that they have no legal defense to this case, appellants seek to avoid payment of their debt by endeavoring to assert the doctrine of equitable recoupment. The doctrine has occasionally found support in tax cases. *Bull v. United States*, 295 U.S. 247; *Stone v. White*, 301 U.S. 532. In recent years, however, the area in which the doctrine is applied has been consistently narrowed. *McEachern v. Rose*, 302 U.S. 56; *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296. Indeed, this Court has already ruled that the Supreme Court has so narrowed the doctrine in tax cases as to virtually extinguish it. *Wells Fargo Bank & Union Trust Co. v. United States*, 245 F. 2d 524.

Even if the doctrine might appear to be applicable here, appellants fail to meet the tests of application. The basis for their assertion of equitable recoupment is that the 1942 renegotiation debt should be forgiven because of losses incurred by appellants in 1944 and 1945. But the explicit terms of the Renegotiation Act unequivocally prohibit such a carry-back of losses in determining excessive profits. Section 403(a)(4)(C), *infra*, p. 30. In addition, these losses arose out of the operation of a steel works by appellants and in no way were connected with the plumbing and heating contracts from which excessive profits were realized in 1942. Unless the losses arise out of the same transaction or circumstances, the doctrine of equitable recoupment cannot be asserted. *Bull v. United States*, *supra*; *Stone v. White*, *supra*.

II. As cross-appellant, the Government asserts that the District Court erred in failing to award interest for the ten years from the date of demand in 1946 until the redetermination of appellants' excessive profits by the Tax Court in 1956. It is true that the award of interest and the rate of interest are discretionary. *United States v. Bonnell*, *supra*; *United States v. United Drill & Tool Corp.*, 183 F.2d 998 (C.A.D.C.); *United States v. Edward Valves, Inc.*, 207 F.2d 329 (C.A. 7), cert. den., 347 U.S. 934. Nevertheless, the Government believes that to reward a contractor who has flouted a Congressional mandate to pay its renegotiation debt⁶ by forgiving ten years of interest con-

⁶ Under § 403(e)(2) of the Renegotiation Act, Congress has provided that the filing of a petition in the Tax Court shall not operate to stay the duty to pay a renegotiation debt or the Government's suit in the District Court to recover the debt. 50 U.S.C. App. 1191.

stitutes plain abuse of discretion by the District Court. The duty to pay this public debt at all times existed. Regardless of whether the Tax Court, as here, reduced the excessive profits or whether, as here, there were years of dispute as to tax credit between the appellants and the Commissioner of Internal Revenue, it was impossible for appellants to be prejudiced by any overpayment of taxes or renegotiation liabilities because adequate machinery for repayment of such overpayments together with interest had been established by Congress. 50 U.S.C. App. 1231(f); *Stow Mfg. Co. v. Commissioner*, 190 F.2d 723 (C.A. 2), cert. denied, 342 U.S. 904; *United States v. Failla*, 219 F.2d 212 (C.A. 3); *Jackson v. United States*, 242 F.2d 333 (C.A. 6).

ARGUMENT

I

The District Court Was Plainly Correct in Refusing to Reduce the Amount of the Renegotiation Debt Finally Determined by the Tax Court and in Refusing to Consider 1944-1945 Losses.

A. Appellants Have No Defense to This Suit to Recover a Simple Debt.

As the pleadings below show, this suit involves nothing more than an action by the United States to recover a simple debt. In its third amended complaint, the United States pleaded the determination of excessive profits by the War Department Price Adjustment Board acting under due authority, the redetermination of excessive profits by the Tax Court in the amount of \$66,700, and the reduction of the principal debt of \$66,700 by a tax credit under § 3806 of the Internal Revenue Code of 1939 in the amount of \$10,553.98 (R.

28-31). These allegations are admitted in appellants' answer to the third amended complaint (R. 33). Thus, there is no dispute between the parties of whether or not the debt exists. Hence, appellants, who have refused to pay their renegotiation debt for approximately thirteen years, now have seized on allegedly "equitable" reasons in justification of their refusal to pay.

That the sole function of the Government's suit below is to recover a debt is conclusively established by the circumstances under which the amount of a renegotiation debt is determined.⁷ Congress, after having provided authority for administrative unilateral determination of amounts of excessive profits by the renegotiators, provided that a dissatisfied contractor could petition the Tax Court for a redetermination of the amount of its excessive profits. With respect to fiscal years ending before July 1, 1943, Congress specifically provided, in § 403(e)(2) of the 1943 Act (50 U.S.C. App. 1191):

Any contractor or subcontractor * * * aggrieved by a determination of the Secretary * * * with respect to a fiscal year ending before July 1, 1943, as to the existence of excessive profits, * * * may * * * file a petition with the Tax Court of

⁷ The Court of Appeals for the District of Columbia Circuit has said that "sums due the United States upon renegotiation are clearly debts. The contractor owes the United States because the United States has overpaid him." *United States v. United Drill & Tool Corp.*, 183 F.2d 998, 1000 (C.A.D.C.). The Tax Court and the Court of Claims agree. *Larrabee v. Stimson*, 17 T.C. 69, 76; *Putnam Tool Company v. United States*, 147 F. Supp. 746 (C. Cls.), cert. den., 355 U.S. 825.

the United States for a redetermination thereof
* * *

In § 403(e)(2), Congress further provided that a Tax Court proceeding involving fiscal years ended before July 1, 1943 (the period here) would be subject to the same provisions as in the case of a Tax Court redetermination for fiscal years ending after July 1, 1943. With respect to this latter period, Congress provided in § 403(e)(1) of the Renegotiation Act, insofar as a Tax Court proceeding was concerned, that:

* * * Upon such filing such court shall have *exclusive jurisdiction, by order, to finally determine the amount, if any, of such excessive profits* received or accrued by the contractor or subcontractor, and such determination shall not be reviewed or redetermined by any court or agency. The court may determine as the amount of excessive profits an amount either less than, equal to, or greater than that determined by the Board. * * * [Emphasis added].⁸

This unambiguous statutory language makes it perfectly “clear”, as observed by the Court below, “that the Tax Court’s determination of the amount of the

⁸ Recognizing that contractors who have filed petitions in the Tax Court might consider the filing of a petition a reason for not paying their renegotiation debts during the pendency of the Tax Court proceeding, Congress, in addition to specifically providing for the filing of suits in courts of the United States to recover the indebtedness, provided that the “filing of a petition [in the Tax Court] under this subsection shall not operate to stay the execution of the order of the Board under subsection (c)(2).” It is subsection (c)(2) which authorizes actions “on behalf of the United States * * * in the appropriate courts of the United States” (50 U.S.C. App. 1191).

principal debt is *res judicata* and binding upon this Court.” (R. 63).⁹

The Court of Appeals for the Eighth Circuit, in a case on all fours with the present one, summarized the settled law (*Bass v. United States*, 221 F. 2d 494, 496-7, cert. den., 350 U.S. 827):

We think the District Court could not, under the circumstances, logically have done otherwise than grant the motion of the United States for a summary judgment. As the District Court ruled, the decision of the Tax Court in the redetermination proceeding initiated by the defendants in that court, which proceeding was between the same parties with respect to the same claim, was *res judicata* not only as to all questions presented to the Tax Court but as to all questions which could have been presented to that court. *Tait v. Western Maryland R. Co.*, 289 U.S. 620, 623, 53 S. Ct. 706, 77 L.Ed. 1405; *Guettel v. United States*, 8 Cir., 95 F. 2d 229, 230-231, 118 A.L.R. 1060;

⁹ The District Court’s statement that the Tax Court’s determination of the principal amount of the debt is *res judicata* and binding on the Court is a clear statement of the law as reflected in numerous decisions on both renegotiation matters and tax questions. See *Bass v. United States*, 221 F.2d 494 (C.A. 8), cert. den., 350 U.S. 827; *Ring Construction Corp. v. United States*, 178 F.2d 714 (C.A. 8), cert. denied, 339 U.S. 943; *Ring Construction Corp. v. United States*, 102 F. Supp. 569 (C. Cls.), cert. den., 343 U.S. 953; *International Building Co. v. United States*, 199 F.2d 12 (C.A. 8), rev’d. on other grounds, 345 U.S. 502; *Continental Petroleum Co. v. United States*, 87 F.2d 91 (C.A. 10), cert. den., 300 U.S. 679; *Rubel Co. v. Rasquin*, 43 F. Supp. 111, aff’d., 132 F.2d 640 (C.A. 2); *United States v. Maguire*, 42 F. Supp. 337 (N.J.); *Monjar v. Higgins*, 39 F. Supp. 663, aff’d., 132 F.2d 990 (C.A. 2); *Pelham Hall Co. v. Carney*, 27 F. Supp. 388, aff’d., 111 F.2d 944 (C.A. 1); *Pelham Hall Co. v. Hassett*, 147 F.2d 63 (C.A. 1).

Pelham Hall Co. v. Hassett, 1 Cir., 147 F. 2d 63, 66-67 and cases cited; International Building Co. v. United States, 8 Cir., 199 F. 2d 12, 18, reversed on other grounds 345 U.S. 502, 73 S. Ct. 807, 97 L. Ed. 1182.

The Tax Court alone had jurisdiction to re-determine the amount of excessive profits realized by the defendants. United States v. California Eastern Line, Inc., supra. Any questions as to jurisdiction of the Under Secretary of War to determine excessive profits or of the Tax Court to decide the issues presented to it and any questions as to the constitutionality of the Renegotiation Act or the proceedings taken under it were subject to review under 26 U.S.C. § 1141. United States v. California Eastern Line, Inc., supra. Since we are convinced that the decision of the Tax Court could not be reviewed, re-opened or collaterally attacked in the District Court and was res judicata as to the validity and amount of the Government's claim, there is no justification for stating the various contentions of the defendants relating to the alleged invalidity of the claim.

In addition, the decision below, granting summary judgment to the United States, is entirely consistent with numerous holdings by this Court, affirming other decisions of the district courts which have without exception granted summary judgment to the United States for the full amount of the principal renegotiation debt. For example, see *Sampson Motors, Inc. v. United States*, 168 F. 2d 878; *United States v. Pownall*, 65 F. Supp. 147, aff'd., 159 F. 2d 73, aff'd., 334

U.S. 742; *United States v. Bonnell*, 180 F. 2d 145. See also, *United States v. Clark*, 72 F. Supp. 393 (Ore.), where the Court cogently and accurately described the renegotiation collection process:

The * * * Board makes a unilateral determination of the amount due as excessive profits and demands immediate payment. This is followed by suit in the District Court, *to which the contractor may not make a defense. He may not defend, because the Tax Court has been given exclusive jurisdiction to try his case de novo. The Tax Court's decision is final and not reviewable. Going into the Tax Court does not stay the case in the District Court. The case passes to judgment summarily.* (p. 394) [Emphasis added].

The foregoing authorities, we submit, conclusively establish that the Court below correctly decided that appellants have no legal defense to this action to recover a simple debt. Accordingly, it is not surprising that appellants, in this Court assert no legal defense to the Government's suit and endeavor, instead, to evolve an equitable defense. Thus, appellants here seek to avoid payment of their debts by resort to the doctrine of equitable recoupment. But, as we show below—even if it is assumed *arguendo* that it may be permissible to invoke the doctrine notwithstanding the finality of the Tax Court determination—the doctrine of equitable recoupment is rarely applied and, in fact, has never been applied to forgive a debt, where, as here, there is no fixed or specific claim against the creditor.

B. The Doctrine of Equitable Recoupment Cannot be Employed to Forgive the Renegotiation Debt Due the United States Here.

At the outset, it must be noted that appellants assert no specific claim against the United States which should be set off against their renegotiation debt. Appellants nevertheless urge that the renegotiation debt finally and conclusively determined to be due the United States by the Tax Court should be forgiven under the doctrine of equitable recoupment. Appellants primarily rely on two tax cases, *Bull v. United States*, 295 U.S. 247, and *Stone v. White*, 301 U.S. 532, and on such cases as *Clinkenbeard v. United States*, 88 U.S. 65, 21 Wall. 65. But, in all of these cases, when the doctrine of equitable recoupment has been applied, the defendant had a specific claim against the plaintiff arising out of the same facts giving rise to plaintiff's suit which, while valid, was unenforceable. For example, in *Bull v. United States*, a taxpayer had overpaid his taxes, and his cause of action to recover the overpayment was barred by the statute of limitations, i.e., the claim existed but his remedy was barred. The Supreme Court permitted the Court of Claims to apply the doctrine of equitable recoupment when the Government sued to recover a deficiency for another taxable year arising out of the same transaction from which the taxpayer had overpaid his taxes. The Supreme Court applied the doctrine, noting that "recoupment is in the nature of a defense arising out of some feature of the action on which plaintiff's action is grounded."

In the more recent cases, however, the Supreme Court and numerous courts of appeals, including this

Court, apparently concerned with the implications of a comparatively broad application of the doctrine of equitable recoupment as stated in *Bull v. United States* and *Stone v. White*, have consistently narrowed the application of the doctrine. See *McEachern v. Rose*, 302 U.S. 56; *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296. Thus, this Court, in *Wells Fargo Bank & Union Trust Co. v. United States*, 245 F. 2d 524 (1957), recently made it clear that it fully shares the current view that the *Bull* and *Stone* cases have been so narrowed as to have virtually no value as precedents. In its *Wells Fargo* opinion, this Court said, at p. 535:

Suffice to say that the so-called equitable doctrine of estoppel and equitable recoupment is based primarily upon the two Supreme Court cases, *Bull v. United States*, 1935, 295 U.S. 247, 55 S. Ct. 695, 79 L. Ed. 1421 and *Stone v. White*, 1927, 301 U.S. 532, 57 S. Ct. 851, 81 L. Ed. 1265. Further, that this equitable doctrine is predicated upon the peculiar equity involved in the respective cases. In subsequent decisions the Supreme Court and lower Court restricts the doctrine to the factual situation of those cases, and narrowed the effect thereof to the point that led Judge Frank, of the Second Circuit, to say:

“The gap in statutes of limitation created by the recoupment doctrine in tax cases seemed at one time to be fairly wide. But the gap has been narrowed markedly by *McEachern v. Rose*, 302 U.S. 56, 58 S. Ct. 84, 82 L. Ed. 46, and *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 67 S. Ct. 271, 91 L. Ed. 296. Frankly, we do not know just how much of that doctrine still lives * * *.”

Wood v. United States, 2 Cir., 1954, 213 F. 2d 660, 661, affirming, D.C.S.D.N.Y., 1953, 121 F. Supp. 764. [Footnote omitted].

In any event, it cannot be challenged that the doctrine of equitable recoupment, when asserted as a defense, must arise "out of some feature of the transaction upon which the plaintiff's action is grounded." *Bull v. United States, supra*. Wholly apart from the effect of recent cases, the doctrine of equitable recoupment never permitted "one transaction to be offset against another, but only * * * permit[ted] a transaction which is made the subject of suit by a plaintiff to be examined in all its aspects * * *". *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 299.

The record here plainly shows that the alleged claim which appellants seek to have offset against the renegotiation debt admittedly owed to the Government has no relation to the transactions giving rise to this debt.

The debt here arose as a result of the renegotiation of appellants' 1942 contracts, and the determination of excessive profits covered the fiscal period March 27, 1942 to December 31, 1942 (R. 29, 33). The 1942 contract gross earnings resulting in the determination of excessive profits for the period March 27, 1942 to December 31, 1942 totalled \$486,987 (R. 7, 8). All of these contracts were completed by appellants on or before December 31, 1942 (R. 7, 8). The record sets these contracts out in detail (R. 7, 48). More than 80% of the renegotiated 1942 income was derived from appellants' performance as a subcontractor installing plumbing and heating equipment at an air base at Walla Walla, Washington (R. 8, 48). For the doctrine of equitable recoupment to have any possible applica-

tion, it would be necessary for appellants to establish that the claim, which they would offset against the debt, arose in some way out of their performance of 1942 plumbing and heating contracts from which they realized excessive profits.

Appellants do not even attempt to show that their alleged claim arose out of the 1942 contracts in question. Instead, they seem to rely on losses incurred by them on other contracts in the years 1944 and 1945. But the Tax Court, which had sole jurisdiction to determine the amount of the 1942 renegotiation debt,¹⁰ as the trial court properly pointed out, refused to admit evidence pertaining to these losses because such evidence was "immaterial and incompetent" (R. 41), i.e., could not be used to reduce the debt. The statute, as already noted, expressly prohibits the use of such losses to reduce the debt, *supra*, p. 8. Moreover, appellants' losses in 1944 and 1945 were actually derived almost entirely from its operation in those years of a "Steel Works Division" of their partnership (R. 37). The steel works apparently was entirely unsuccessful since it operated at losses exceeding \$250,000 during 1943, 1944, and 1945 and was abandoned by appellants. (R. 37) In the course of abandoning the steel works, appellants incurred further losses of more than \$75,000 during 1943 and 1945 (R. 37).

Thus, the record shows that the post-1942 steel works losses were not even remotely related to the performance of the plumbing and heating subcontracts com-

¹⁰ In the exercise of its exclusive jurisdiction, the Tax Court did in fact reduce the principal renegotiation debt from \$80,000 to \$66,700 because the Court felt that appellants were entitled to a salary allowance whereas the renegotiators had made no allowance. In the Tax Court, the Government conceded that a salary allowance was proper. (R. 55).

pleted in 1942 and from which the excessive profits in question were realized. Indeed, appellants do not make any claim that the steel works losses were derived from or in any way were connected with the contracts from which excessive profits were realized. Consequently, even in its present narrow application under the more recent cases, the facts here entirely preclude the application of the doctrine of equitable recoupment to this case.

As shown above, appellants have and assert no legal defense to the Government's action to recover the renegotiation debt. In addition, appellants' so-called equitable defense is equally lacking in merit. It is submitted that this Court should therefore affirm the decision below, granting summary judgment to the Government, with respect to appellants' liability for the debt.

C. Appellants' Arguments are Without Merit

Appellants argue (App. Br., pp. 9, 10) that to allow the Government to recover this admitted debt is "unjust, oppressive and inequitable" because in years subsequent to the renegotiated 1942 year, appellants' partnership sustained a loss on its war contracts and from sales for all of the World War II years made a total profit of only approximately \$8,700. As shown above, the losses in 1944 and 1945 were almost entirely due to operating losses in appellants' abortive effort to establish a steel works in Portland and in losses resulting from the sale and abandonment of the steel works.

These steel works losses may have been due to inept management, improper financing, or any number of

other possible causes. If the losses were incurred without fault or negligence on the part of appellants, relief presumably could have been sought in accordance with the procedure set up by Congress under the War Contracts Hardship Claims Act (Lucas Act), 60 Stat. 902, 62 Stat. 992. If the losses were due to the termination of Government contracts, relief could have been sought pursuant to the provisions of 41 U.S.C. 107. If the losses occurred because of errors in contract negotiations, delay due to slow priorities, or allocations, or for similar reasons, relief could have been applied for under the First War Powers Act, 50 U.S.C. 61, and the various Executive Orders issued thereunder. The record below is silent as to whether appellants invoked any of these avenues of relief. Certainly, their failure to do so should not be allowed to work a forfeiture of the renegotiation debt admittedly due the Government.

Appellants further complain that the court below erred in striking appellants' second defense which was designed to plead the facts pertaining to the Tax Court's exclusion from evidence of statements intended to show the losses incurred in 1944 and 1945. The trial court held that the subject matters of the second defense were "matters of law which were fully determined by the Tax Court's determination [of the amount of the debt] and that this Court does not have jurisdiction of the matters so raised * * *." (R. 66).

Appellants apparently now believe that the Tax Court correctly excluded from evidence facts with respect to post-1942 losses which appellants had strenuously insisted the Tax Court should admit during the trial (App. Br., pp. 17-20). Appellants correctly state

that the Tax Court excluded the evidence because of the provision in the Renegotiation Act prohibiting the Tax Court from applying carry-overs or carry-backs of losses in determining excessive profits (App. Br., p. 18). See Section 403(a)(4)(C), *infra*, p. 30. With this, of course, the Government is in agreement with the Tax Court.¹¹ Here, contrary to their Tax Court position where they insisted the Tax Court could consider the question, appellants assert that what they were really attempting to present to the Tax Court was the doctrine of equitable recoupment. They then argue that since, under the decision of the Supreme Court in *Commissioner v. Gooch Milling & Elevator Co.*, 320 U.S. 418, the Tax Court has no equitable jurisdiction, it could not and did not pass on the so-called equitable defense. From this, appellants argue that the court below should have considered the equitable defense.

Appellants confuse the issue. The Tax Court was *not* refusing to exercise equitable jurisdiction when it rejected the evidence of losses in later years. Neither was the court below. The Tax Court was merely following a Congressional mandate to not allow as

¹¹ Appellants' arguments shift with the wind. Appellants now say that the Tax Court correctly excluded evidence relating to losses in post-1942 years, that the losses may now somehow be used as an offset to reduce their admitted renegotiation debt. On the other hand, in the Tax Court, appellants insisted that the post-1942 losses were an *element* in determining 1942 excessive profits, i.e., the renegotiation debt. In his Tax Court reply brief, present counsel for the appellants stated:

The position of the petitioner was and as stated by its counsel in the opening statement and in the petition, namely, losses in other war years are a factor to be considered in determining whether the petitioner had an excess profit. [T.C. Reply Br., p. 3].

items of cost in 1942 determinations of excessive profits amounts representing carry-backs of losses from subsequent years even though such carry-backs may have been permissible for income tax purposes. Section 403(a)(4)(C), *infra*, p. 30. The court below, in recognizing that the Tax Court has exclusive jurisdiction to determine the amount of excessive profits, properly pointed out that the District Court does not have jurisdiction to reduce the principal debt by offsetting post-1942 losses because “the law is clear that the Tax Court’s determination of the amount of the principal debt is *res judicata* and binding on this Court.” (R. 63). The rejection by the court below of appellants’ “equitable” basis for forgiving the debt was thus plainly correct.

In substance, what appellants seek is a forfeiture of the 1942 debt by “equitably” carrying back 1944-1945 losses—i.e., *they seek to do by indirection something which Congress has expressly prohibited the Tax Court, in the exercise of its exclusive jurisdiction, from doing directly*. Surely, appellants’ efforts to circumvent the statute cannot acquire the dignity of a valid defense merely by the gratuitous designation of a pleading as a “defense of equitable recoupment.”

II

The District Court Erred in Failing to Award the United States Interest from the Date of Initial Demand for Payment in 1946.

Attached to the third amended complaint as Exhibit B is a copy of the War Department Price Adjustment Board’s notice dated December 18, 1945 to appellants advising them of the determination of excessive profits of \$80,000 for fiscal 1942 and demanding payment of

that amount less applicable tax credit by January 8, 1946. The notice also advised appellants that interest would accrue at the rate of 6% per annum from and after January 8, 1946 on any amount of the renegotiation debt unpaid as of that date (R. 10, 11, 29, 30, 31). In their answer to the third amended complaint, appellants admitted the demand and advice to them that interest would accrue after January 8, 1946 (R. 33).

The court below, relying on *United States v. Star Construction Co., Inc.*, 186 F. 2d 666 (C.A. 10), ruled that the judgment herein should bear interest at the rate of 4¼% from September 5, 1956, the date upon which the Tax Court redetermined excessive profits in the amount of \$66,700, rather than 4¼% from January 8, 1946, the date of demand for payment of the 1942 renegotiation indebtedness.¹²

It is true that the award of interest under the Renegotiation Act is a matter of judicial discretion. See *United States v. Bonnell*, *supra* (C.A. 9); *United States v. United Drill & Tool Corp.*, *supra* (C.A.D.C.); *United States v. Edward Valves, Inc.*, 207 F.2d 329 (C.A. 7), cert. den., 347 U.S. 934; *Ring Construction Corp. v. United States*, 209 F.2d 668 (C.A. 8). It is our

¹² The Renegotiation Act is silent on the question of interest. Hence, various district courts have awarded interest at various rates in an exercise of judicial discretion. In previous cases in Ninth Circuit district courts, the Government has been awarded interest at the rate of 6%. In *Sampson Motors, Inc. v. United States*, 168 F.2d 878, and *United States v. Pownall*, 159 F.2d 73, aff'd., 334 U.S. 742, for example, the Ninth Circuit affirmed the District Court's award of 6% interest from the date of demand for payment. However, in recent cases in the District Court in Oregon, interest in renegotiation collection suits was awarded at the rate of 4¼%. Hence, in its amended complaints herein, the Government prayed for interest at 4¼%, the rate awarded by the court below.

position, however, that the court below abused his discretion in denying the Government approximately ten years of interest.

This abuse of discretion is, we submit, attributable to the failure of the court below to give proper weight to the facts (1) that appellants have had and continue to have uninterrupted use of public funds since January 8, 1946 and (2) have deliberately avoided a Congressional order to pay a public debt when, at all times, they were assured of the recovery (with interest) of any overpayments which may have been made, either because of erroneous tax credit computation or Tax Court redetermination of a reduced principal debt. See 50 U.S.C. App. 1231(f).

As we have already noted, the decision below, in refusing to award interest from 1946, relies heavily on *United States v. Star Construction Company, supra*. But the *Star Construction Company* case is easily distinguished on the ground that there the United States failed to allege and prove that any demand for the payment of the debt was made prior to the filing of the complaint. Here, the record is clear that demand for payment was made on December 18, 1945 (R. 11). Moreover, the rationale of the *Star Construction Company* decision—i.e., that where the amount of tax credit was in dispute and was determined at the time of trial, the United States was not entitled to interest prior to judgment because the sum was indefinite, unliquidated, and disputed—has been rejected by other courts considering the interest question. Thus, in *Stow Mfg. Co. v. Commissioner*, 190 F.2d 723 (C.A. 2), cert. den., 342 U.S. 904, Judge Learned Hand pointed out that if there were errors in tax credit computations, they may

be corrected under the Internal Revenue Code and any overpayments or underpayments because of tax credit errors may be adjusted administratively or by subsequent litigation.¹³ Again, in *United States v. Failla*, 219 F.2d 212 (C.A. 3), the contractor resisted summary judgment in a renegotiation collection case, because the alleged tax credit was too low and, the contractor argued, the debt was unliquidated. In affirming the award of summary judgment to the United States and the award of interest from the date of demand in spite of the tax credit dispute, the Third Circuit held that the fact that the tax credit was disputed and the debt theoretically unliquidated did not deprive the United States of the right to summary judgment and to interest from the date of demand. As in *Stow*, the Court pointed out that any alleged errors in tax credit computations may be corrected in the usual procedure under the Internal Revenue Code either by administrative proceedings or by litigation. The Sixth Circuit reached the same result in *Jackson v. United States*, 242 F.2d 333.

These cases show that the proper procedure for a renegotiated contractor who disputes the tax credit and thus claims the renegotiated debt is unliquidated is to pay the amount of excessive profits less the al-

¹³ Administrative adjustment is exactly what occurred in this case where the tax credit was variously computed and pleaded and settled during the period from 1949 to 1956 (R. 18, 20, 25, 30). Further, appellants resisted the Commissioner's computation of their taxes for 1942 and, hence, in part caused the indecision with respect to tax credit. This indecision continued until August 1, 1953, when appellants and representatives of Internal Revenue Service settled their dispute, making a final computation of tax credit then possible for the first time (R. 39, 40). These circumstances, far from justifying a forgiving of ten years' interest, emphasize the necessity for prompt payment of renegotiation debts.

lowed tax credit, then seek a refund from Internal Revenue Service based on the amount of additional tax credit the contractor contends should be allowed. As the above cases show, if Internal Revenue Service fails to act on the claim in six months, the Internal Revenue Code permits the contractor to sue to recover the balance of the claimed tax credit. Under these circumstances, in the *Failla* and *Jackson* cases, the courts of appeals upheld the district court's exercise of discretion in allowing interest on these renegotiation debts *from the date of demand* to the date of judgment.

In *United States v. Employers Mutual Casualty Company*, 226 F.2d 895, the Eighth Circuit held that the District Court had abused his discretion in failing to award the United States interest from the date of default when a surety had failed to respond to a valid demand for payment. The interest, the Eighth Circuit said, was "an appropriate measure of damage for the delay in payment" (p. 900). Not only did the Eighth Circuit rely on cases asserted here by the Government (p. 898) but the court specifically rejected a contention apparently relied on by the district court below in this case, that "the longer the lawsuit remained in court, the longer the surety was relieved from payment of interest." (p. 900).

In line with the foregoing decisions, this Court, in *Sampson Motors, Inc. v. United States*, 168 F.2d 878, 879, after quoting extensively from *United States v. Strontium Products Co.*, 68 F. Supp. 886, including statements from *Billings v. United States*, 232 U.S. 261, that the United States is entitled to interest from the date of demand, allowed 6% interest on a renegotiation debt *from the date of demand*. This Court

quoted the following pertinent language from the *Strontium Products Co.* case:

Allowance of interest at a fair rate from the date of default on the principal sum [renegotiation debt] found to be due is an appropriate measure of damages. * * * The tenor of the Act clearly reveals a Congressional purpose to effect speedy collection. The provision authorizing review by the Tax Court is specifically limited so as to not operate "to stay the execution of the order of the Board". * * * *Such a statutory policy makes it essential to exact interest from the contractor who refuses to pay, and who retains the use of the money while depriving the Government of its use, so as not to penalize prompt contractors who comply with the letter and spirit of the Act.* [Emphasis added].

Similarly, in *United States v. United Drill & Tool Corp.*, 183 F. 2d 998, the Court of Appeals for the District of Columbia Circuit said that "sums due the United States upon renegotiation are clearly debts" and that the "contractor owes the United States because the United States has overpaid him." Interest, therefore, runs from the date upon which the contractor fails to make repayment, after proper notice.¹⁴ Further, contrary to the holding below that interest

¹⁴ For other cases where district courts have awarded the United States interest on renegotiation debts from the date of demand, whether or not the contractor had filed a petition in the Tax Court, see *United States v. Union Concrete Pipe Co.*, 93 F. Supp. 650 (D.C. W.Va.); *United States v. Clark*, *supra* (D.C. Ore.); *United States v. Grob, Inc.*, 132 F. Supp. 493 (D.C. Wisc.); *Ring Construction Corp. v. United States*, 209 F.2d 668 (C.A. 8); *United States v. Philmac Mfg. Co.*, 192 F.2d 517 (C.A. 3).

runs only from the date of the Tax Court's 1956 decision, the fact that appellants filed a petition in the Tax Court seeking a redetermination of their excessive profits is no reason for depriving the Government of interest from the 1946 date of initial demand. As the Eighth Circuit said in ruling on an identical contention in *Bass v. United States*, 221 F. 2d 494, cert. den., 350 U.S. 827:

The defendants' assertions that interest should have been allowed only from the date of the Tax Court's decision is, in our opinion, not tenable. It was on August 30, 1944, that the amount of excessive profits was determined by the Undersecretary of War. * * * The determination was made under the authority of law and, we think, was presumptively correct from its inception. * * * Under the circumstances, the liability of the defendants accrued as of August 30, 1944, and interest ran from that date. (p. 497)

We submit that the foregoing authorities call for a ruling here that the court below abused his discretion in failing to award the Government interest from the date of demand in 1946.¹⁵

¹⁵ As the record shows, a sum of \$7,815.03 otherwise due to the estate of one of the partners was not paid to the estate by the Government but was withheld and applied to a reduction of accrued interest on April 20, 1954 (R. 31, 34, 70). One result of the failure of the court below to award the Government interest prior to September 5, 1956 is that the \$7,815.03 has been applied to a reduction of principal as of April 20, 1954. Thus, even though the memorandum opinion below states that the Government is entitled to judgment in the principal amount of \$56,146.02 (R. 65), the court ordered summary judgment in the principal amount of \$48,330.99 (\$56,146.02 less \$7,815.03) (R. 70, 71). See footnotes 4, 5, *supra*, p. 6.

CONCLUSION

For the forgoing reasons, it is respectfully submitted that the judgment below (1) should be affirmed on the main appeal and (2) should be modified on the cross-appeal with instructions to the court below to enter judgment in the amount of \$56,146.02 together with interest thereon at the rate of $4\frac{1}{4}\%$ per annum from January 8, 1946 less the sum of \$7,815.03 applied to accrued interest as of April 20, 1954.

Respectfully submitted,

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JULY 1958.

APPENDIX

Excerpts from pertinent statutes

Renegotiation Act of 1943 (50 U.S.C. App. 1191)

403(a)(4)(C):

Notwithstanding any of the provisions of this section to the contrary, no amount shall be allowed as an item of cost (i) by reason of a recomputation of the amortization deduction pursuant to section 124 (d) of the Internal Revenue Code until after such recomputation has been made in connection with a determination of the taxes imposed by Chapters 1, 2A, 2B, 2D, and 2E of the Internal Revenue Code for the fiscal year to which the excessive profits determined by the renegotiation are attributable or (ii) *by reason of the application of a carry-over or carry-back under any circumstances*. The absence of such a recomputation of the amortization deductions referred to in clause (i) above shall not constitute a cause for postponing the making of an agreement, or the entry of an order, determining the amount of excessive profits, or for staying the elimination thereof. [Emphasis added.]

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402(c)(2):

Upon the making of an agreement, or the entry of an order, under paragraph (1) by the Board, or the entry of an order under subsection (e) by The Tax Court of the United States, determining excessive profits, the Board shall forthwith authorize and direct the Secretaries or any of them to eliminate such excessive profits (A) by reductions in the amounts other-

wise payable to the contractor under contracts with the Departments, or by other revision of their terms; or (B) *by withholding from amounts otherwise due to the contractor any amount of such excessive profits*; or (C) by directing a contractor to withhold for the account of the United States, from amounts otherwise due to a subcontractor, any amount of such excessive profits of such subcontractor; or (D) *by recovery from the contractor, through repayment, credit, or suit any amount of such excessive profits actually paid to him*; or (E) by any combination of these methods, as is deemed desirable. *Actions on behalf of the United States may be brought in the appropriate courts of the United States to recover from the contractor any amount of such excessive profits actually paid to him and not withheld or eliminated by some other method under this subsection.* The surety under a contract or subcontract shall not be liable for the repayment of any excessive profits thereon. Each contractor and subcontractor is hereby indemnified by the United States against all claims by any subcontractor on account of amounts withheld from such subcontractor pursuant to this paragraph. All money recovered in respect of amounts paid to the contractor from appropriations from the Treasury by way of repayment or suit under this subsection shall be covered into the Treasury as miscellaneous receipts. Upon the withholding of any amount of excessive profits or the crediting of any amount of excessive profits against amounts otherwise due a contractor, the Secretary shall certify the amount thereof to the Treasury and the appropriations of his Department shall be reduced by an amount equal to the amount so withheld or credited. The amount of such reductions shall be transferred to the surplus fund of the Treasury. In eliminating excessive profits the Secretary shall allow the contractor or subcon-

tractor credit for Federal income and excess profits taxes as provided in section 3806 of the Internal Revenue Code. For the purposes of this paragraph the term “contractor” includes a subcontractor. [Emphasis added.]

* * * * *

403(e)(1)

Any contractor or subcontractor aggrieved by an order of the Board determining the amount of excessive profits received or accrued by such contractor or subcontractor may, within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the last day) after the mailing of the notice of such order under subsection (c) (1), file a petition with The Tax Court of the United States for a redetermination thereof. *Upon such filing such court shall have exclusive jurisdiction, by order, to finally determine the amount, if any, of such excessive profits received or accrued by the contractor or subcontractor, and such determination shall not be reviewed or redetermined by any court or agency.* The court may determine as the amount of excessive profits an amount either less than, equal to, or greater than that determined by the Board. A proceeding before the Tax Court to finally determine the amount, if any, of excessive profits shall not be treated as a proceeding to review the determination of the Board, but shall be treated as a proceeding de novo. For the purposes of this subsection the court shall have the same powers and duties, insofar as applicable, in respect of the contractor, the subcontractor, the Board and the Secretary, and in respect of the attendance of witnesses and the production of papers, notice of hearings, hearings before divisions, review by the Tax Court of decisions of divisions, steno-

graphic reporting, and reports of proceedings, as such court has under sections 1110, 1111, 1113, 1114, 1115(a), 1116, 1117(a), 1118, 1120 and 1121 of the Internal Revenue Code in the case of a proceeding to redetermine a deficiency. In the case of any witness for the Board or Secretary, the fees and mileage, and the expenses of taking any deposition shall be paid out of appropriations of the Board or Department available for that purpose, and in the case of any other witnesses, shall be paid, subject to rules prescribed by the court, by the party at whose instance the witness appears or the deposition is taken. *The filing of a petition under this subsection shall not operate to stay the execution of the order of the Board under subsection (c) (2).* [Emphasis added.]

403(e)(2):

Any contractor or subcontractor (excluding a subcontractor described in subsection (a)(5)(B)) aggrieved by a determination of the Secretary made prior to the date of the enactment of the Revenue Act of 1943, with respect to a fiscal year ending before July 1, 1943, as to the existence of excessive profits, which is not embodied in an agreement with the contractor or subcontractor, may, within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the last day) after the date of the enactment of the Revenue Act of 1943, file a petition with The Tax Court of the United States for a redetermination thereof, and any such contractor or subcontractor aggrieved by a determination of the Secretary made on or after the date of the enactment of the Revenue Act of 1943, with respect to any such fiscal year, as to the existence of excessive profits, which is not embodied in an agreement with the contractor or subcontractor, may, within ninety days (not counting Sunday or a legal holiday

in the District of Columbia as the last day) after the date of such determination, file a petition with The Tax Court of the United States for a redetermination thereof. Upon such filing such court shall have the same jurisdiction, powers, and duties, and the proceeding shall be subject to the same provisions, as in the case of a petition filed with the court under paragraph (1), except that the amendments made to this section by the Revenue Act of 1943 which are not made applicable as of April 28, 1942, or to fiscal years ending before July 1, 1943, shall not apply.

* * * * *

Internal Revenue Code of 1939 (26 U.S.C. 1141):

Courts of review

(a) The courts of appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of title 28 of the United States Code.

(b) Venue

(1) In general. Except as provided in paragraph 2, such decisions may be reviewed by the court of appeals for the circuit in which is located the collector's office to which was made the return of the tax in respect of which the liability arises or, if no return was made, then by the United States Court of Appeals for the District of Columbia.

(2) By agreement. Notwithstanding the provisions of paragraph 1, such decisions may be reviewed by any court of appeals, or the United States Court of Appeals for the District of Columbia, which may be designated by the Commissioner and the taxpayer by stipulation in writing.

(3) Application of subsection. This subsection shall be applicable to all decisions of the Tax Court rendered on and after May 10, 1934, and section 1002 of the Revenue Act of 1926, 44 Stat. 110, as in force prior to May 10, 1934, shall be applicable to such decisions rendered prior thereto, except that paragraph 2 of this subsection may be applied to any such decision rendered prior to May 10, 1934.

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United States
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for the Ninth Circuit

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Appellants,

v.

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Appellee.

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LIGHT, Executor of the Estate of Betty Rushlight, deceased,
Appellees.

APPELLANTS' REPLY BRIEF

*Appeals from the United States District Court for the
District of Oregon.*

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**REPLY TO THE GOVERNMENT'S ARGUMENT AS
TO THE EQUITABLE DEFENSE**

The Government argues that the doctrine of the *Bull* and *Stone* cases is inapplicable because (a) appellants have no fixed or specific claim against the Government for their losses (Br. 14, 15), (b) the doctrine of these cases has been so narrowed that they are not

applicable (Br. 15, 16) and (c) the facts alleged in the second defense have no relation to the transaction giving rise to the debt (Br. 17, 18) (*Bull v. United States*, 295 U.S. 247, 55 S Ct 695, 79 L ed 1421; *Stone v. White*, 301 U.S. 532, 57 S Ct 851, 81 L ed 1265).

All of these arguments are at least doubtful. In addition the Government does not even answer our argument, nor distinguish the authorities we have cited, which would deny recovery on an inequitable claim even where there is no specific or fixed cross claim.

(a) Appellants Have An Equitable Cross Claim For Their Losses.

Concededly, appellants do not have an enforceable cross demand for the recovery of their 1944 and 1945 losses on renegotiable war business (any more than the taxpayer had such a claim in the *Bull* and related cases). There, as here, any such claim has long since been outlawed. However, under the War Contracts Hardship Claims Act (Lucas Act) 60 Stat. 902, 62 Stat. 992, 41 U.S.C.A. Sec. 46, Note, Congress recognized that there was a duty on the part of the Government to reimburse war contractors for losses incurred under war contracts or subcontracts. Assuming such a duty, then appellants should, at least in equity, have a cross demand which could be offset against the Government's claim for 1942.

(b) The Doctrine of the Bull and Stone Cases Will Be Applied In An Appropriate Situation.

In the case of *Wells Fargo Bank & Union Trust Co. v. U. S.*, 9 Cir., 1957, 245 F 2d 524, cited by the Government (Br. 16) this court found it unnecessary to determine the extent of the doctrine of equitable recoupment as the Government had a statutory remedy. However, the Second Circuit, quoted by this court (Judge Frank in *Wood v. United States*, 2 Cir., 1954, 213 F 2d 660), has had occasion quite recently to examine and apply this doctrine in the face of arguments similar to those made by the Government in the case at bar. (See *Cuba Railroad v. U. S.*, 2 Cir., 1958, 254 F 2d 280, a recent opinion by Judge Learned Hand which would indicate that there is considerably more vitality to this doctrine than was once supposed.)

(c) The Appellants Renegotiation Liability For The War Years Constitutes a Single Transaction.

On this aspect of the case, the Government's position is entirely too restrictive. In this case we are dealing with (a) a single period, i.e. the war years, (b) one Renegotiation Act, (c) one partnership, (d) the total renegotiable sales and contracts of such partnership.

The Renegotiation Act itself was purposely made broad enough to encompass any kind of war contract or sales regardless of the underlying product or service. Therefore, under the Act, whether the sales and contracts related to plumbing or steel would be immaterial. The question is whether the appellants realized excessive profits on their war contracts and sales without regard to what the particular product may have been.

(d) Equitable Principles Will Be Applied Even Though Appellants Have No Cross Claim.

It can be argued, as the Government has done, that “recoupment” does not apply because the appellants have no specific claim against the Government. However, even assuming that such is the case, the *Stone* case goes beyond recoupment or set-off and holds that a claim based upon *indebitatus assumpsit* (as the Government’s case is here) will not be enforced where it is inequitable to do so.

This distinction is recognized in the discussion of the cases in this area contained in Mertens, Law of Federal Income Taxation, Section 60.05 (chap. 60, page 19) where the author, after discussing the *Stone* case says, “The decisions just referred to are not set-off or recoupment decisions; they are decisions involving the pleading of an *equitable defense*.” (Author’s emphasis).

Furthermore, a careful review of the cases that we have cited in our opening brief will reveal that in many of those cases there was no cross claim. The court refused to enforce the Government’s claim for money because under all of the circumstances it was unjust and inequitable to do so. In the case at bar, even assuming that there was no duty on the part of the Government to reimburse appellants for their losses, and that appellants have no claim or demand for their recovery, the fact remains that the Government is suing appellants to recover excessive profits when they in fact had *no* profits, excessive or otherwise.

THE GOVERNMENT'S CLAIM FOR INTEREST

Everything that we have said in our opening brief and this brief as to the equities of the Government's position is applicable to the question of whether the lower court abused its discretion in not allowing interest.

As to this aspect of the case, the Government entirely misconstrues the basis on which interest is allowed. However, even under such misconstruction, the lower court was correct in not allowing interest. In its brief, the Government argues that the appellants had the use of the excessive profits and therefore should pay interest on such sum. However, such was not the case as any such profits were immediately wiped out by the losses in the subsequent years. Appellants did not have the use of such money—it was lost in connection with contracts and sales subject to renegotiation.

The applicable rules as to the allowance of interest in a renegotiation case are laid down by this court in *United States v. Bonnell*, 9 Cir. 1950, 180 F 2d 145 as follows:

“ . . . on the merits we agree with the contractors that interest is not automatically allowable, but is to be denied where its recovery would be inequitable . . . not only the allowance or disallowance of interest but also the rate is discretionary with the court, . . . ”

The Government takes the position that interest is allowable in every case where the defendant has had the use of the plaintiff's money. That this is a misconception is shown by the case relied upon by this court

in the *Bonnell* case, namely, *Board of County Comm'rs of Jackson County v. United States*, 1939, 308 U.S. 343, 60 S Ct 285, 84 L ed 313, where the court said:

"The cases teach that interest is not recovered according to a rigid theory of compensation for money withheld, but is given in response to considerations of fairness. *It is denied when its exaction would be inequitable.*" (Emphasis supplied).

Respectfully submitted,

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Attorneys for Appellant and
Cross Appellees.

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PETITION OF APPELLANTS AND CROSS
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**PETITION OF APPELLANTS AND CROSS
APPELLEES FOR REHEARING EN BANC**

To the HONORABLE RICHARD H. CHAMBERS,
STANLEY N. BARNES and FREDERICK G.
HAMLEY, Circuit Judges of the United States Court
of Appeals, Ninth Circuit:

The appellants respectfully petition the court for a
rehearing of the appeal in the above matter, and re-
spectfully suggest that such rehearing be before the
court en banc, on the grounds that:

(1) Admittedly there were no excessive profits for the war years. The court erred in its conclusion that the district court was powerless to grant relief in an action brought to recover non-existent excessive profits;

(2) Such inequitable conclusion is in disregard of the nature of the government's action and established precedents. It reduces the district court from a court of general jurisdiction to the status of a collection agency, and appellants are deprived of any opportunity to assert the meritorious defense that they had *no* excessive profits.

(a) Rehearing Should Be Held En Banc

In the majority opinion, the court said:

"No doubt if the district court's judgment is upheld the defendants have paid dearly for their business experience with the government. The situation pulls at one's sympathy, but we have determined it is not in our sphere, or the district court's sphere, to grant the relief we would like to grant. Therefore, the judgment must be affirmed." Op. p. 2.

This is tantamount to holding (1) that an unjust and inequitable judgment was entered and is being affirmed, and (2) a district court is absolutely powerless to prevent such a result.

Presumably under our legal system a just and equitable result should follow in each case, and a district court has the power to see that such is the case. We respectfully suggest that where it is felt that a contrary position must be adopted, the matter is of sufficient importance and far reaching effect to warrant the attention of the entire court.

(b) This Court Is Not Powerless to Act

If this were an action in which the matters pleaded by appellants had been considered, or could have been considered by the tax court, then it would undoubtedly be correct to say that the appellants had had their day in court and the district court would be in effect an “enforcement agency in the vicinage of the contractors.” Op. p. 3.

That was the case in *Bass v. United States*, 8 Cir., 221 F2d 494, relied upon by this court. However, in that case the finality given the tax court’s determination was specifically restricted to questions which either were presented or could have been presented to that agency. Therefore, we respectfully disagree with the court that the *Bass* case is decisive here. Admittedly the defensive matters pleaded by the appellants were not considered by the tax court. Nor does the opinion herein appear to hold or suggest that we were in error in our contention that that so-called “court” was and is an administrative agency without the equitable powers of a district court.

On the score of refusal to apply “equitable recoupment” the court has spoken with apparent finality. Equitable recoupment of course assumes that the appellants have a cross-demand against the government which an equity court would set off or recoup. However, the court does not squarely face the other facet of our argument relating to the inherent nature of the government’s action. As was held in *Stone v. White*, 301 US 532, this is an action in the nature of *indebitatus assumpsit* for money had and received; to recover upon

rights equitable in nature; and to avoid unjust enrichment by the defendant at the expense of the plaintiff. The courts have continued to cite and apply this case in rare but proper situations.

The sole question in the case at bar is whether or not the appellants were and are, in equity and good conscience, indebted to the United States. That is the basis of the government's action. While it is true that carryovers or carrybacks are not allowed, this was an inhibition placed on the renegotiators and the tax court, and is not an inhibition on the inherent equity powers of a district court.

This court assumes that the tax cases which refuse to apply the doctrine of *Stone v. White* are based on restrictions on the power of a court. However, such restrictions are really based on specific statutory inhibitions as is illustrated by the case of *McEachern v. Rose*, 302 US 56, decided after the *Stone* case and cited in *Rothersies v. Electric Storage Battery Co.*, 329 US 296. In the *McEachern* case the taxpayer was suing to recover a refund in two open years based on the manner in which an installment sale had been reported. Admittedly there was a deficiency in a prior closed year when the sale should have been reported. Therefore the taxpayer in equity and good conscience was not entitled to recover. This case, like the case at bar, was one in which there were different years involved. As to the general power of a court in such circumstances, the court said, "We may assume that, in the circumstances, equitable principles would preclude recovery in the ab-

sence of any statutory provision requiring a different result." But then the court pointed out that Congress had specifically provided that an outlawed deficiency could not be offset against a claim for refund, and therefore had specifically precluded the court from applying the equitable principles which it recognized. The same thing was true in the *Rothensies* case where the statute of limitations applied.

No such specific statutory inhibition exists under the Renegotiation Act. The provisions as to carrybacks and carryforwards relate to the powers of the tax court and the negotiators. They do not purport to inhibit a district court from applying general equitable principles. In *McEachern v. Rose* the court was prepared to apply such principles even in a situation involving different tax years and where there was no statutory scheme of carryovers and carrybacks.

When Congress left the matter of finally determining the 1942 renegotiation of appellants to the tax court, it must have done so with full cognizance of the nature and powers of that administrative agency. When it provided for an action against the contractors on a renegotiation liability in a district court, it also must have been fully cognizant of the nature of such an action which would include the power to deny a recovery where such recovery would be completely inequitable as in the case at bar.

Therefore, this court is in error in its previous opinion when it says that inequities under this wartime statute are beyond adjustment.

(c) Conclusion

For the above reasons we respectfully submit that this case should be reheard, and because of its importance, that such rehearing should be by the court en banc.

Respectfully submitted,

HUTCHINSON, SCHWAB & BURDICK,
DENTON G. BURDICK, JR.,
Attorneys for Petitioners and
Appellants and Cross-Appellees.

CERTIFICATE OF COUNSEL

IT IS HEREBY CERTIFIED that in the judgment of the undersigned, the foregoing petition for a rehearing is well-founded, and is not interposed for delay.

Dated at Portland, Oregon,

October 27, 1958.

DENTON G. BURDICK, JR.,
Of Counsel for Petitioners and
Appellants and Cross-Appellees.

